The New York Certified Public Accountant

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BOOK REVIEWS

Fundamental Principles of Accounting

By C. A. Moyer and H. T. Scovill. JOHN WILEY & SONS, INC., New York, 1954. Pages: 631; $6.00.

This new book on the basic principles of accounting is intended as a first-year text in that subject. Is it a good book? Yes, it is; in fact, it's very good. It is written in good business English. It proceeds from the simple to the complex smoothly and naturally, starting with a single trading proprietorship, then proceeding to a trading partnership and a trading corporation, and ending with a glimpse of the adaptability of accounting to other phases of our business and economic life, e.g., Manufacturing (Cost) Accounting, Government Accounting, Budgeting, etc. The aim throughout the book has been to emphasize the bedrock principles, and to show how adaptive these principles are to the needs of our expanding economic life with its ever larger and larger business units. By way of illustration of this point, the subjects of Branch Accounting and Accounting for Multiple Departments are discussed. The authors have not failed to emphasize throughout that the purpose of collecting financial and cost data, and summarizing it in statement forms, is to help management, owners, and others appraise the progress of the business and to diagnose its financial condition.

Each chapter is followed by pertinent questions and problems. There is in preparation a "Workbook for Problems" to accompany the text: it will contain the necessary journal, ledger paper, etc. In addition, an "Illustrative Problem" is being prepared for use during the study of the second half of the book. Actual business forms and books of account will be simulated in this problem. This wedding of practice to theory, as expounded by Professors Moyer and Scovill,—each of whom, by the way, has over twenty years of teaching experience behind him—guarantees a solid grounding in accounting fundamentals to the first year student.

RUSSELL G. DAVY
New York University

Guidebook to New York State Income Taxes on Individuals, Partnerships, and Fiduciaries

By Samuel M. Monatt. COMMERCE CLEARING HOUSE, Chicago, Ill., 1954. Pages 258; $5.00.

This tax guidebook answers a great need of long standing for a guidebook to New York State Income Taxes, similar to J. K. Lasser's guidebook to U. S. Income Taxes on Individuals. As such, it can be very useful to individuals, partnerships, and

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Book Reviews

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fiduciaries in making out their own tax returns, as well as to professional accountants.

"One picture is worth a thousand words." This book has illustrations of filled-out tax forms for all of the following:

Form 101—Certificate of Taxpayer Claiming Residence.
Form 102—Report of Tax Withheld at Source.
Form 103—Report of Tax Withheld at Source—Summary.
Form 105—Report of Information at Source.
Form 106—Annual Summary and Letter of Transmittal.
Form 200—Optional N. Y. State Resident Return.
Form 201—N. Y. State Resident Return.
Form 202—Unincorporated Business Tax Return.
Form 203—Non-Resident Return.
Form 204—Partnership Return.
Form 204A—Apportionment of Net Income and Net Capital Gain (or Loss) of Partnership Having a Non-Resident Member and Carrying on Business Both Within and Without the State.
Form 205—Fiduciary Return.
Form 205A—Apportionment of Income for Non-Resident Beneficiary.
Form 207—Farm Schedule of Income and Expenses.
Form IT-115—Notice of Change in Net Income by U. S. Treasury Department.

Each specimen return is discussed in detail following the reproduction of the return and, superimposed upon the returns, are the numbers of the relevant paragraphs in the text. Within these paragraphs, reference is made to the New York State Law and Regulations and, also, to the Internal Revenue Code or Regulations 118, whenever a federal analogy exists. Not only is a cross reference to the federal Code made by paragraph and section number, but the New York State treatment is compared with the federal treatment for each item of the instructions. This is an invaluable service, especially where there are differences between the two. Also given is a 1954 State Tax Calendar, and a Comparison of Income and Deductions for State and Federal Income Taxes.

This guidebook is lucidly written. The type is large and stands out clearly from the white paper stock, making for facile reading. A superlative job.

Russell G. Davy

New York University

Give To American Cancer Society!

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Book Reviews

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Design for Decision

By Irwin D. J. Bross. THE MACMILLAN COMPANY, New York, 1953. Pages: 276; $4.25.

Statement on Auditing Procedure No. 1 (of the American Institute of Accountants) says this: ". . . the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries." To what extent should the independent auditor in forming his opinions rely upon "investigations, tests, and inquiries"? Meaningful answers to this question are given in *Design for Decision.* This book is a down-to-earth, readable explanation of statistical decision-making that deserves to be widely read by accountants.

In the work of the accountant, is the process of inference more intuitive than objective? The thoughtful accountant-reader will develop new ideas on this subject as he compares the attitudes that have grown out of his personal experience with statisticians' notions of the process of inference ("the procedure for going from a sample [data] and structural knowledge [model] to a statement"). There are discussions of how bias (both prejudicial and *non-prejudicial*) affects the reliability of data and thus the inferences drawn from it.

The author gives as the three basic components of astute decision-making: (1) a Prediction System that deals with alternative futures, (2) a Value System that handles various conflicting purposes, and (3) a Decision Criterion that integrates the other two components and selects an appropriate action. Accountancy's primary concern is with profit-determination (through cost-revenue matching) and the arraying of historical-cost residuals as a "snapshot" of financial position. But the impact of future events upon today's accounting measurements is perhaps greater than we realize. The implications of the decision-making procedure that Bross outlines will be an eye-opener in this respect.

Although this book is written for a general audience, you cannot read it and fail to obtain a broader conception of what "objectivity" means from the standpoint of the accountant. You will have a clearer notion of what constitutes the scope and force of the "auditor's judgment". Also, this hors d'oeuvre is likely to whet your appetite for a heavier helping of statistical theory and its potential uses for arriving at solutions to accountancy's problems.

COLIN PARK

The University of Buffalo
Buffalo, New York

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Book Reviews

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Pricing and Estimating Methods for the Boxboard Container Industry

By Norman J. Elliott, C.P.A., Haywood Publishing Company of Illinois, Chicago, Ill. 44 p. $5.00.

This is an integrated reprinting of a series of articles which originally appeared in the trade publication, *Boxboard Containers.* It will unquestionably become a standard reference guide for pricing and estimating by manufacturers of setup paper boxes, folding cartons, corrugated boxes and paper tubes. Mr. Elliott wisely and advantageously makes considerable use of illustrative form and chart materials alongside of descriptive text, facilitating visualization and grasp of the suggested techniques.

After a brief introduction into cost accounting concepts, the author reviews cost rate-setting procedures, the use of budgets, time-cost relationships and production standards. The basic principles for the setting of machine-hour rates which he applies to the boxboard industry may be used profitably in other manufacturing activities. It may be noted that the production methods in the boxboard industry are similar to those used in the graphic arts and allied fields. The relative effectiveness of a fixed and flexible budget is described, the latter defined as "a number of related parallel budgets prepared on a comparative basis for a series of significant changes in the production or sales level of an organization". The discussion of comparative hourly rates at varying capacity levels introduces a dynamic extra-dimensional quality to the subject of pricing and estimating. The separate chapters which deal with "Estimating Setup Paper Box Costs", "Estimating Folding Carton Costs" and "Estimating Corrugated Box Costs" contain a synthesis of expert guidance, the result of extensive experience in these fields.

This compilation primarily directed to the attention of people in the industry may be studied beneficially by any cost-conscious person who agrees with the author that "pricing your product without knowing its cost is an exercise in faith and chance."

Sidney Blumenberg

New York, N. Y.

Forms Control: A Management Tool to Cut Clerical Costs

By N. O. Couvillon. Bureau of Business Practice, New London, Conn., 1953. Pages: 19; $.50 (minimum order, $1.00; special quantity discounts available.)

This little booklet indicates how management can cut down its paperwork, thus conserving time, manpower and money.

AN ADIRONDACK VIEW

Sawdust, no, not stardust; let's keep our feet on the ground even though our wagons are hitched to the stars. Have you traveled through Vermont or the Lake George approach to the Adirondacks lately? At a speed low enough so you could observe the country side? Then you have seen those huge piles of woodworking, machine tool cuttings commonly, called sawdust.

It's not dust at all. The bigger and better the saws get, the bigger grow the cuttings. If they were metals, they would probably get fed back into the melting pot.

So a fortune awaits you—if you can find a way to use the stuff and get it off the landscape. Can't you make it into a plastic for shoe soles? Can't you mix it with tar and black-top roads and fill road-holes with it?

Well, it's your problem, all we can do besides our accounting, and our hard life in the mountains, is hatch the idea. Perhaps there is a way to add artificial flavoring, roast it—and solve the super-problem of 1954—the coffee problem.

LEONARD HOUGHTON, C.P.A.

"Adirondack Chapter"

Reminder of

1954 PRIZE ESSAY CONTEST!

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest (1) among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State for at least one semester (or quarter) between September 1, 1953, and June 30, 1954, and (2) among non-certified members of the staff of any New York State office of CPA firms engaged in the public practice of accountancy. The article may cover any topic in the field of accounting and/or auditing.

In each of these classes, prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners in each class and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double-or triple-space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

★

The name of the individual submitting a paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be submitted in duplicate, accompanied by a covering letter giving the contestant's name and address and all other information required to show conformity by the contestant with the terms, rules and conditions of the contest. When submitted to the judges, each manuscript will be given a key number for identification.

★

Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before June 15, 1954. Awards will be announced as soon thereafter as possible.

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All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes or which of the prize-winning papers, if any, will be published.

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BUSINESS AND PERSONNEL OPPORTUNITIES

BUSINESS OPPORTUNITIES

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Some Observations on the Direct Cost Method

By JOHN B. INGLIS, C.P.A.

The author of this paper doubts that the Direct Cost method will accomplish the near-miracles its advocates sometimes claim for it. After pointing out its weaknesses, he indicates the advantages attributed to the orthodox absorption method of cost accounting. He evaluates the Direct Cost method in the light of ARB #29, and concludes that it is neither a generally accepted accounting principle nor generally acceptable to the Treasury Department for the purpose of computing inventories used in determining taxable income.

MR. JONATHAN HARRIS and others have written extensively about the principles of direct costing so it is unnecessary for me to explain them here. There is nothing I wish to add from the point of view of the application of direct costing for management purposes. In fact I will not take issue with the method if it is the kind of cost application a management thinks it needs for its own use to enable it to make money for its stockholders. There are many kinds of cost systems which managements find useful, and the costs derived thereunder include overhead in varying degrees.

The current interest in direct costing is surprising in view of what appears to be a rather limited use of the technique, even for internal purposes, as indicated in N.A.C.A. Bulletin 23, issued in April, 1953. Apparently even fewer companies use it in their published financial accounts. Nevertheless it has been discussed widely in recent months, at the latest N.A.C.A annual conference in Los Angeles, at the American Institute of Accountants annual meeting in Chicago, and elsewhere.

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Mr. Inglis was a member of the Institute's Committee on Accounting Procedure when A. R. Bulletin No. 29 was issued. He is now a member of the Executive Committee of the American Institute of Accountants.

This paper was presented by Mr. Inglis at a technical meeting of the Society on the subject of Direct Costing, in which Mr. Harris also participated. It was held in the Engineering Societies' Building on November 12, 1953, under the auspices of the Committee on Cost Accounting and Inventory Methods.

It seems improbable that all this interest and discussion indicates we are on the verge of adopting brand new accounting principles, for such principles are developed slowly as their usefulness is demonstrated. Could it be a matter of simplicity versus significance? If the proponents of direct costing are right, we accountants have served our economy badly in accepting the accounting principles which have been so widely applied by industry over so many years. I don't believe we have served industry so badly. Moreover I doubt the direct cost method will accomplish the near-miracles the advocates sometimes claim for it. Those things just don't happen in accounting.

According to N.A.C.A. Research Bulletin 23, the earliest published description of direct costing was written by Mr. Harris and published in the N.A.C.A. Bulletin in January, 1936. However, it appears there have been a few applications of the method going back at least as far as 1919. There has also been interest in the subject in Great Britain for many years. In view of the length of time the method has been known, its record of acceptance by industry is not impressive. On the other hand the LIFO principle has made rapid strides in recent years. According to the study of 600 companies made by the American Institute of Accountants in 1952, LIFO was in use by 183 companies. LIFO, of course, is aimed at charging current costs against current revenues and there is a certain parallel between it and the principle of direct costing. If, as now seems likely, the principle of LIFO or market, whichever is lower, wins acceptance for income tax purposes, the LIFO principle will no doubt be even more extensively applied. Should that occur, discussion of direct costing, at least for financial accounting and tax purposes, may become academic.

Some Points Against Direct Costing

Before considering whether the principles of direct costing are in accordance with accepted accounting principles, I should like to advance a few thoughts against the principles of direct costing.

1. The advocates of direct costing admit that under their system, overhead must still be allocated to products in some manner in order to determine full costs for purposes of long-range pricing policy. It might be argued that if full cost information is required anyway it might as well be a part of the general records rather than prepared on a memorandum basis.

2. There is the practical difficulty of distinguishing between variable costs to be included in inventory and fixed costs to be charged direct to profit and loss in the period incurred. Many costs do not clearly fall into one category or the other and must be allocated on a somewhat arbitrary basis. Moreover, such allocation might be subject to managerial whim and inconsistency in application.

3. Direct costing can be criticized in theory because it obviously does not give the full cost of the product. Moreover, all product costs are by nature similar, and the only justification for treating some costs differently from others would appear to be simplicity and practicality. One writer put it this way:

> "In spite of the admitted difficulties of matching costs and revenues, it is hard to see how the fixed costs of manufacturing facilities can be excluded from inventories if profits are to be measured as the difference between cost of making a product and the revenue obtained from it. This puts undue strain on the work cost." [1]

Others have taken the position that direct costing does not solve, but avoids, the cost accounting problems brought on by fluctuating volume of production.

[1] John A. Beckitt, *An Appraisal of Direct Costing,* N.A.C.A. Bulletin, December 1951.

I wish to point out that LIFO, an accepted basis, while it often results in an extremely low carrying value for inventories, is nevertheless a cost basis. This can hardly be said of direct costing.

4. The proponents of direct costing maintain that the method gives management better information when considering the advisability of adding products to the line, because the direct cash outlay involved is clearly set forth. Thus it is more easily understood, they say, that any amount of sales above the direct cost will apply against fixed overhead and thereby increase the overall profits. This seeming advantage may be accompanied by a danger, namely, that management will, in its natural desire for increased volume, be inclined to underprice products. In this regard, I noted from its annual published reports that the Dewey and Almy Chemical Company, which uses and advocates the direct cost principle and with which Mr. Harris was for many years associated, increased its sales from $12,600,000 in 1946 to $29,100,000 in 1952; however, despite this significant increase in volume, net profit in 1952 of $657,000 was actually less than in 1946, when it was $720,000. Of course direct costing may have had no bearing on these operating results, but on the face of things there would seem to be cause for conjecture.

In my opinion, there is danger in the idea, which is not new but seems to be popular at this time, that any additional business which recovers something more than direct costs is worth taking on. We sometimes hear that theory expressed in my profession of public accounting, and some go so far as to say that when your men are idle any income producing work they might do, even though it be at less than salary cost, improves your profits to that extent. However, there are indications that any organization which allows its thinking to be too much influenced in this direction may eventually find itself with all marginal business and very little profit.

5. The advocates of direct costing often give examples to prove that absorption accounting gives distorted operating results when production and sales fluctuate. While there may be some merit in their argument, it would appear that the same could be said of direct costing in certain situations. An example would be an industry where through mechanization a major part of product costs were fixed. Or a company which produces nine months of the year for seasonal sales in the remaining three months. Again, if shipments were withheld owing to strikes in customers' plants direct costing could not be applied. Moreover, if the guaranteed annual wage becomes a reality, will this be treated as a fixed period cost?

6. Again referring to the annual published reports of the Dewey and Almy Chemical Company, I note that the inventory basis is stated to be "not in excess of either cost or market." This is vague and uninformative, and there is no accompanying note of explanation. The independent public accountant's opinion contains no exception, which would indicate that in this particular case the direct cost method has a relatively minor effect on the annual accounts. This assumption is borne out by a note in a recent Dewey and Almy prospectus which states that certain indirect factory overhead expenses having no significant relation to production volume have been excluded in the valuation of inventories, but that their exclusion does not materially affect either the balance sheets or the profit and loss statements.

In view of the apparent minor effect of direct costing on the Dewey and Almy financial statements, I find myself asking, "Why all this clamor about the benefits of direct costing?" I am forced to conclude that the principal benefits must be in the area of internal cost information.

7. While the proponents claim that

direct costing makes for stability in profit reporting, it might be argued that it improperly equalizes periodic profits.

The Case for the Absorption Method of Cost Accounting

The absorption or full cost orthodox method of cost accounting has these advantages:

1. It conforms to theoretical considerations in that it treats all product costs as being essentially of the same character. Moreover, full cost is a more definite concept than direct cost, and is less prone to arbitrary decisions and managerial whim than the latter.
2. Absorption costing presents a problem only when production and sales fluctuate substantially from period to period. However, accepted and tested methods such as normal burden rates, budgets and forecasting are available to cushion the impact of such fluctuations.
3. Opponents of absorption costing say that the method causes companies to report profits on the mere production of goods (by taking fixed costs into inventory), whereas in their opinion profits are properly derived only from sales. Nevertheless, it would seem that a good case can be made for showing favorable earnings in a period of building up inventory. Management generally will not make something it does not expect to sell, and if it cannot dispose of the stock the principle of reduction to market will take hold. The case for profit on production is further strengthened where the production is covered by sales orders.
4. An absorption cost accounting system can be readily maintained in such a way as to show both direct costs and full costs. Thus far internal purposes the important advantages of both the direct cost and full cost methods are available to management, while the external reporting can continue on the basis presently accepted by the tax authorities, Securities and Exchange Commission, and the accounting profession. Many companies employing the LIFO basis for income tax and annual reporting purposes use another cost method for internal accounting purposes throughout the year.
5. The study of variances which come to light in an absorption cost system may be tedious and difficult but often lead to conclusions of value to management.

Direct Costing Method Evaluated in the Light of ARB 29

As I have previously indicated, if a management wants to adopt direct costing for internal accounting purposes after considering all the arguments that may be advanced against it, that is its decision. If, however, a company is considering adopting direct costing for inventory pricing and reporting income to stockholders, it must be considered from the point of view of generally accepted accounting principles, particularly American Institute of Accountants Bulletin 29 on Inventory Pricing, issued in July 1947.

I was a member of the committee that issued Accounting Research Bulletin 29. Its principal purpose was to narrow the area of differences in practice in pricing inventories, particularly in write-downs to market. It established a floor below which inventories should not be written down. There is nothing in the committee's correspondence about giving recognition in the Bulletin to direct costing, nor do I recall any discussion of it among the committee. It is evident, therefore, that at the time this Bulletin was considered, direct costing was not regarded as a serious question. On the other hand the Bulletin gives recognition to the "first-in, first-out", "average" and "last-in, first-out" methods. It also recognizes that there should be considerable room for judgment in each individual situation and in determining the allocation of overhead.

It is now generally understood that

"accounting is not essentially a process of valuation but the allocation of historical costs and revenues to the current and succeeding fiscal periods." [2]

Recognition of this concept, which paralleled the shift in emphasis to the income statement, likewise offers the basic tenet for dealing with the subject of inventory pricing. Inventories are not deferred charges to cash but deferred charges to future income. The determination of income is now the more important objective in the pricing of inventories (excluding the exceptional circumstances involving questions of insolvency or liquidation) and in the pricing procedure the matter of valuation is a factor only as a limitation upon the result.

Therefore, the amount at which an inventory is stated at any given date is not primarily a recognition of value, but is intended to measure the portion of the stream of costs incurred in acquiring and producing goods which can reasonably be applied to revenues of the future, with profit-making effect. It is a deliberate step in the matching of costs against revenues.

This leads to a conclusion that the primary basis of stating inventories is cost, but only in the sense and to the extent that such cost is deemed to be properly allocable against revenues of ensuing periods.

The following statements in Bulletin 29 have a bearing on the question of direct costing:

Statement 2:

"A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues."

The discussion of Statement 2 in the Bulletin includes this explanation:

"In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is in effect a residual amount remaining after the matching of absorbed costs with concurrent revenues. This residual is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward."

Statement 3:

"The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."

The discussion of Statement 3 says in part:

"In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost, and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges."

Another comment in the discussion is that

"It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application."

Statement 4:

"Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as "first-in, first-out", "average", and "last-in, first-out"); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income."

[2] "Accounting Principles Underlying Corporate Financial Statements," The Executive Committee of the American Accounting Association, June 1941.

In Bulletin 29 the statement was made for the first time that the exclusion of *all* overheads from inventory costs does not constitute an accepted accounting procedure. However, the Bulletin goes on to emphasize the importance of judgment in individual situations, involving consideration of the adequacy of cost procedures, the soundness of the cost principles and the consistency of their application. It is a well known fact that in actual practice the extent to which overhead is included in inventory pricing varies considerably as between companies, and it is probably safe to say that few, if any, companies include all items of overhead in inventory valuation.

Since the issuance of Bulletin 29 a number of accounting firms have found it necessary to qualify the accounts of clients because of the exclusion of all overhead from inventories. An important one, where the amount is material, is E. R. Squibb & Co.

You might ask why Bulletin 29 was not made more specific as to the meaning of cost and items that should be included in overhead. This detail was omitted intentionally and I think wisely. It must be remembered that the bulletins are designed to meet the problems of industry as a whole. The variety of circumstances encountered make it impracticable and inadvisable, in my opinion, to lay down rigid definitions of cost, overhead, etc., in a bulletin on inventories. The purpose of the Bulletin was to provide a framework of principles which would be a guide without being a strait-jacket.

Is Direct Costing in Conformity with Generally Accepted Accounting Principles?

The three statements I have quoted from this Bulletin obviously must receive serious attention in considering whether a particular application of direct costing is in conformity with generally accepted accounting principles.

Whether direct costing can be applied instead of the present generally accepted methods of accounting for inventories depends on consideration of these two facets of the problem:

1. *The financial accounting aspect:*

In financial statements presented to stockholders in annual reports, the current form of auditor's certificate states that

> "the accounts are maintained in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

We must accept the fact that the direct costing method is not at present a generally accepted accounting principle. Whether it results in a fairer presentation of income than first-in, first-out, average cost, or LIFO is a question which can be debated.

2. *The tax problem:*

At present direct costing as it is commonly understood is not generally acceptable to the Treasury Department for the purpose of computing inventories used in determining taxable income.

Tax Regulations Concerning Valuation of Inventories

§ 39.22 (c)—2 Valuation of inventories.

(a) Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

* * *

§ 39.22 (c)—3 Inventories at cost. Cost means:

* * *

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

* * *

In July, 1953, the Treasury Department amended its Regulation 111, Sec. 29.22 (a) 5 regarding the determination of gross income. Subsequent to amending this Regulation, the Treasury Department issued Ruling 141, in which it stated that the purpose of amending the Regulation was to permit taxpayers to follow accepted accounting practice in their trade or business. As stated in the ruling, "The regulations . . . now conform to accepted principles of cost accounting. . . ."

In order to get the Treasury to accept the direct cost method it would have to be demonstrated to them that it results in a fairer presentation of income than do present methods. That remains to be demonstrated.

* * *

Accounting principles are based on their usefulness and after that has been demonstrated they duly receive acceptance. The LIFO principle when first evolved received very limited acceptance but was finally recognized for income tax purposes because it had received some measure of recognition and use by industry. It was a cost method and it was believed that it resulted in a proper determination of income. The development of LIFO for tax purposes and financial accounts proves that a new concept of inventory pricing can achieve acceptance over a relatively short period. If it can be demonstrated that the direct costing method has a usefulness not only to management but also as a basis for reporting income to stockholders and for stating inventories in balance sheets, it is not too much to expect that it might also receive in course of time general acceptance similar to that now accorded to LIFO. Whether that happens, however, depends on its usefulness being demonstrated to a greater degree than has been done up to the present time.

Some Thoughts on the "Direct Cost" Method for Valuing Inventories

By A. R. KASSANDER, C.P.A.

In this paper the author examines the Direct Cost method from the viewpoint of whether its claimed advantages do actually yield the benefits attributed to them, since he believes that if the method is a desirable basis for valuing inventories, adverse technical considerations may be resolved without great difficulty. However, he concludes that for manufacturing business in general there is little, if any, advantage in changing to the Dircet Cost method for valuing inventories; also, that the proposed method may, in fact, result in the loss of significant managerial information.

FROM time to time during the last fifteen years or thereabouts there has occurred periodic discussion of the pros and cons of the "direct cost" method for valuing inventories. Recent interest in the subject has increased to a marked degree as a result of adoption of the method by a number of companies. The proposed method has received considerable attention at meetings of accounting organizations and in accounting literature.

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Under the direct cost method charges to work in process account and subsequent transfer to finished goods account with eventual disposition through cost of goods sold are restricted to direct material, direct labor and direct or variable production overhead expenses. Fixed expenses are not considered as attaching to the product but are deemed to be costs attributable to the period in which they are incurred and are thus currently charged directly to income. Illustrative of the type of expenses which are considered to be fixed are the following: salaries of factory superintendent, general foremen, factory administrative and clerical staff, receiving, warehouse and shipping forces; factory office and miscellaneous shipping department supplies, building maintenance, heating and lighting costs; fire insurance, depreciation, real estate taxes, etc.

Advantages Claimed for the Method

The objective of the method, as stated by some of its advocates, is to produce a reported monthly gross profit which varies directly with sales, regardless of manufacturing activity. That is not to say that the rate of

gross profit necessarily remains constant since it is affected by changes in selling prices, changes in sales "mix," raw material costs, wage rates, labor productivity, etc. However, the rate and amount of gross profit as well as net profit are not influenced by the effect on unit costs of fluctuating manufacturing activity which may precede or follow actual sales. No part of fixed expenses is "sold" to inventory; on the contrary, it is all charged to income in the period incurred.

The proponents of the direct cost method claim theoretical soundness for the method in the generally accepted concept that those costs which are functions of time should be recognized in the income account in the period in which they are incurred and that only those costs should be deferred and matched against future income which are functions of output. Fixed manufacturing expenses which continue regardless of activity are deemed to be functions of time and thus are charged to income account in the period in which they are incurred.

The advocates of this method claim further that it results in more useful information to management since the income account on its face discloses the gross margin available for absorption of all fixed expenses regardless of type and thus more clearly sets forth the effect on profits of volume fluctuations and provides easily understandable data as to the effect of cost fluctuations on the break-even point.

Other advantages claimed for the method are (1) a more tangible and conservative inventory valuation and (2) by eliminating from stated costs those elements which produce fluctuating unit costs, i. e., fixed or "uncontrollable" expense, there is no necessity for establishing "normal" plant capacity and the entire problem of treatment of under- or over-absorbed burden disappears.

Disadvantages of the Method

Disadvantages connected with the method which are recognized but minimized by its advocates are limited to the following items:

Stated amount of working capital is decreased.

Inventories stated under the direct cost method may not be acceptable for federal income tax purposes.

Apparent lower costs may result in practical sales management problems due to the necessity for greater margin between stated costs and selling prices.

The method may be considered by independent public accountants as not in conformity with generally accepted accounting principles, for purposes of published reports.

In the following discussion the stated disadvantages will be discussed only briefly, since they have been covered fully in published material by those opposed to adoption of the method. The author has noted little articulate dissent from the method on the part of practicing cost accountants as a tool of cost accounting and managerial interpretation of operating results. Hence, principal consideration will be given to the question as to whether or not the alleged advantages do in fact yield the benefits which are claimed for them. The author feels that the method should stand or fall on its merits; if the method is a desirable basis for valuing inventories, technical adverse considerations can be resolved without great difficulty.

The question as to conformity with generally accepted accounting principles, including a proper statement of working capital, applies principally to year-end published statements. The direct cost method, on the other hand, is advocated for the most part for presentation of interim monthly reports for management purposes. It would pose no difficult problem to compute a year-end adjustment for the purpose of recognizing the effect of inclusion of fixed charges in the inventories at the beginning and end of the year. On the other hand, it should not be assumed that accepted principles of accounting are so rigid as to preclude a recognition of a practice deemed desirable by a representative

cross section of business. Obviously, adequate disclosure would be required in the year the change became effective. Perhaps one of the most difficult aspects of the change would be the determination of which are the "fixed" expenses to be absorbed in their entirety in the period in which they are incurred.

As to the acceptability of the method for federal income tax purposes, at worst we would have one more case of difference between taxable income and income per books. However, a modification of Regulations to recognize the method where consistently applied is not inconceivable, with provision that no tax deduction could arise from the original write-down to "direct cost."

As to effect on sales organizations as a result of the need for greater margin between stated costs and selling prices, this appears to be purely an administrative problem which it should be possible to work out rather quickly. However, the mere statement of the problem at once brings to mind another problem in connection with pricing and determination of profit by types of product which may upset some of the claimed advantages of the direct cost method.

In a concern which manufactures a variety of products using equipment of different types it is frequently desirable practice to establish departmental overhead rates or in some cases, specific machine rates, so that recorded costs will reflect the use made of the facilities actually employed in the manufacturing processes. It so happens that most of the overhead factors which vary with type of equipment are of a fixed nature, for example, building maintenance, heating and lighting costs, fire insurance, depreciation, real estate taxes, fixed portion of power costs, etc. To the extent that costs are a guide to settling selling prices or measuring relative profitability of products we would be faced with the necessity of establishing varying desirable profit margins. That brings us right back to the problem of determining "normal volume" for absorption of fixed costs. The difference is, that under conventional methods the normal absorption is reflected in the recorded cost, while under the proposed method it would be recognized (if at all) in a different planned gross profit margin for each product.

Considerable effort with some progress has been expended by cost accountants on the problem of allocating selling expenses to product lines. Perhaps one of the reasons for the limited progress lies in the fact that there is no requirement to reflect the allocations in the accounts. Selling expenses are written off as incurred and association with specific product lines, where attempted, is usually used only for management statistics with no overall accounting effect.

In the author's opinion it would be a step backward if, as a result of dissociating fixed factory overhead from product costs in the accounts, we were to lose sight of the effect upon costs of the use of different types of manufacturing facilities.

Discussion of Claimed Advantages

The central point of the entire subject lies in the effect on interim profits of the accounting treatment of fixed manufacturing expenses in a seasonal business where sales do not necessarily parallel production. When sales and production are both up either method produces favorable profit figures. When sales and production are both down either method produces adverse profit figures. When production is up and sales are down the conventional method may produce a more favorable result than the direct cost method as a result of absorbing and thus deferring more fixed cost in inventory than is charged to cost of sales. When production is down and sales are up the opposite effect may be produced due to under-absorption of fixed expenses.

In discussing the subject it is frequent practice to present a tabulation consisting of a comparative income

account for several months in which sales, direct or variable costs *per unit,* fixed manufacturing expenses and general, selling and administrative expenses are all identical. The only difference between months is assumed to be in the volume of production. It is then shown that as a result of overabsorption of fixed overhead in months of high production and underabsorption in months of low production (both over- and underabsorption being taken up in the income account), the recorded net profit fluctuates widely from month to month. Under the direct cost method the net profit will be the same each month since the only costs absorbed by inventory are direct variable costs which are assumed to remain constant per unit.

The following typical questions are then asked: "What is our profit on a given volume of sales?" "How can such inconsistencies be explained?" And then comes the statement to end all argument: "You can't make a profit merely by manufacturing inventory."

Let us overlook, for the purpose of this discussion, that the hypothetical figures are sometimes selected to support the desired conclusions and also that the profit fluctuations may be and frequently are smoothed out by deferring both under- and over-absorption of fixed manufacturing expenses for purposes of interim statements. Let us examine the circumstances just as they are presented.

The proponents of the direct cost method in effect say that there is no difference in measuring results of operations between a manufacturing concern and a mercantile enterprise. They say that the only measure of performance is sales; that no consideration should be given in interim statements to the degree of effective use of manufacturing facilities from month to month. In the opinion of the author this viewpoint is in error. There is a difference in results of operations in a manufacturing business between two months of identical sales, in one of which the plant is shut down and in another of which it is busy preparing for expected future business. To ignore that difference is questionable accounting practice. As hereinbefore stated, if the fluctuating production program is planned that way, the recorded profits may be smoothed out by the device of deferring immediate recognition in the income account of over- or under-absorbed fixed charges.[1]

Obviously, it must be assumed that inventory is accumulated only as appropriate to the needs of the business. An inflated inventory position created solely to absorb fixed expenses may one day result in a write-down in a far greater amount than the fixed expenses included in the stated costs. Mercantile establishments have not been relieved of the danger of inventory write-down merely because they are on a prime or direct cost basis.

Let us consider for a moment the statement, "You can't make a profit by manufacturing for inventory." That brings to mind the story of the manager on a profit-sharing bonus arrangement who increased his income by the simple device of loading up the inventory. Suffice it to say that a Board of Directors that permitted an inventory to grow to a point where it materially affected the manager's bonus, must have spent its meetings discussing fishing instead of balance sheets; and the public accountants who made the year-end examination should have had something to say about that inventory. On the other hand, if the hypothetical new manager was able to take hold of

[1] Attention is sometimes called to the similarity of fixed manufacturing expenses to general, administrative and salling expenses, which are charged to income in the period in which they are incurred, even though future periods may benefit thereby. One major point of difference may be noted, however. The fixed manufacturing expenses which are deferred through absorption in inventory costs are associated with tangible physical inventories. Any selling expenses which one may wish to defer usually could only be associated with intangible prospective sales.

a shop plagued by shortages of all kinds, maintain deliveries to customers and, at the same time, create a sound, balanced inventory under efficient production control, he probably earned his bonus.

It is true that a company cannot increase its profits merely by manufacturing inventory. However, neither need a company lose money when the plant is operating at capacity pursuant to a sound program, merely because sales were not realized in a particular month. To repeat what has been said before, there is more to operating a manufacturing concern than selling.

The income account reflects the results of operations. Those results are materially affected by the utilization of manufacturing facilities. Those results are definitely different for differing rates of manufacturing activity even though sales may not vary. Remember we are discussing primarily interim reports. The final essence of the results of operations is the net income figure. It is unfortunate (management would be much easier were it otherwise) that one figure standing at the lower right hand corner of the income account cannot by itself explain all the factors which contributed to the result. One of the marks of the skilled accountant is his ability to aid management in interpreting financial statements.

To summarize, if it is recognized that the net income figure is merely the final end result of operation and that judicious handling of manufacturing facilities has an important bearing on that result, it may be quite possible to "make money by manufacturing for inventory." Likewise, it may be possible to lose money by not manufacturing for inventory. If a concern accumulates inventory unwisely the resulting loss may be measured by an amount far in excess of the fixed manufacturing cost element. The prevention of that occurrence is not found in the methods of cost accounting.

Other Advantages Claimed for the Method

Let us examine the concept that those costs which are functions of time should be recognized in the income account in the period in which they are incurred, i.e., the distinction between those costs which attach to a period and those costs which attach to product. It appears to the author that to urge this concept in theoretical support of the direct cost method is a distortion of the theory. The criterion as to whether or not a cost should be applied to the income of the period in which incurred is not whether such cost is fixed during the period irrespective of business activity but, rather, whether by its nature it must be absorbed by the income of that period because, either it represents a loss which is "over the dam," or it represents expenditures from which only the current period is deemed to benefit in measurable degree. In the latter category fall most of the selling, general and administrative expenses; in the former, all such factory costs as maintenance of idle plant, excessive labor costs due to inefficiencies, breakdown, green help, etc., excessive waste and spoilage, strike costs, inventory shrinkage and so on. It does not seem logical to say that superintendents' salaries, depreciation and factory office supplies, being fixed expenses, do not attach to the product but that floor sweepers' wages, machine repairs and cutting oil, being variable expenses, do attach to the product.

Another advantage claimed for the method is that it more clearly sets forth the effect on profits of volume fluctuations. Volume of what? The answer, of course, is volume of sales, whereas plant performance depends on volume of production. Though in the long run, we can realize profit only through sale of the product, it is equally true that overhead costs can be absorbed only through production, hence, production must be the basis for measuring plant

performance. Obviously, no business will last long unless sales and production are equalized over a cycle, but as has been stated before, that very important problem of business management is not solved by a particular system of cost accounting. In the meantime, let it be remembered that fixed expense is fully absorbed (however, that absorption may be computed), not at a certain sales level but at a given production level.

Finally, there is the claim that the direct cost method produces a more conservative inventory valuation, with a corollary that write-downs, should they become necessary, will be less severe than under present conventional methods. Even if "conservative" is defined simply as synonymous with "lower" (an untenable definition), the advantage claimed would be short lived. Lower than what? The answer, it seems, must be "lower" than some alternative permissible method or lower than the valuation used by other concerns in the industry. It is difficult enough to have "LIFO" and "FIFO" existing side by side. At least in that case the differences in inventory valuations produced by the two methods rest on varying concepts of the flow of cost of acquisition into cost of sales. The method of computing costs does not vary. It would be a strange state of affairs indeed if two costs, one of which omits a large area of cost included in the other, were both recognized as in conformity with generally accepted accounting principles. So once the proposed method is recognized, comparative conservatism disappears.

As to the increased cushion against inventory write-downs: Without going into all of the ramifications of "cost or market, whichever is lower," let us only consider write-down to replacement cost and write-down to realizable value, less applicable selling, general and administrative expense. In the first circumstance, the lower replacement cost is largely in direct material and labor and possibly in the variable overhead expenses of indirect labor and supplies. Rarely would there be any reduction in the "replacement cost" of fixed expenses.

In the second instance, we now reduce realizable value by a percentage representing selling, general and administrative expense, and perhaps some provision for normal profit, to arrive at sound inventory value. Under the direct cost method we would have to increase the margin to provide for fixed manufacturing expenses. The write-down may work out to be less than under present methods, but it is by no means a mathematical certainty.

Conclusion

All accounting principles must be applied in a manner which gives due consideration to all the circumstances surrounding the concern and type of operation under examination. It may be that under a given set of conditions the direct cost method will produce financial statements which best reflect a company's financial position and results of its operations. The author concludes, however, that for manufacturing business in general there is little if any advantage in changing to the direct cost method for valuing inventories and that the proposed method may, in fact, result in loss of significant managerial information.

Tax Problems of Separation and Divorce

By Matthew F. Blake, C.P.A.

For accountants the principal application of a knowledge of this topic is in the preparation of tax returns for the ex-husband or the ex-wife. However, alimony problems are likely to be presented to them in other ways such as consultations with attorneys concerning divorce settlements which are in the process of negotiation. They may even occur in a distinctly personal manner in the form of a divorce action by a public accountant's wife who feels very much abused because of those lonesome evening hours while her husband attends to such trifles as audit reports and tax returns.

Like many other amendments to the Code looking toward the relief of undue hardships, the alimony sections are an offspring of high tax rates. Prior to 1942, the husband was not allowed a deduction for alimony payments. The double burden of alimony and tax payments did not become really critical until the advent of high war-time tax rates which threatened to put even high income alimony payers on the breadline. As might be expected, pre-1942 decrees have produced a large portion of the tax litigation. However, all too many post-1942 agreements have been caught in a crossfire of overly stringent legislative requirements and conflicting court decisions. Since one of the aims of this presentation is to emphasize that the accountant should exercise a high degree of vigilance in reacting to alimony situations, it appears to be in order to use a few lines to indicate why alimony can be so troublesome in taxation: a—The emotional climate of a divorce action usually is not conducive to carefully reasoned tax planning. b—Since taxability of the alimony to the wife is a condition precedent to the obtaining of a deduction by the husband, a direct conflict of interest often arises which can lead to prolonged wrangling. This conflict may survive the time of negotiating the divorce settlement and become even more acute in later years if the ex-wife or ex-husband should attempt to transfer the tax burden over to the other. c—State divorce laws differ widely and the laws of some states can lead to serious tax complications. d—The applicable sections of the Code were so drawn as to prevent income splitting where there is no bona fide divorce. As income splitting has since been legalized for married couples, this objective has lost its significance and the rigid requirements concerning the divorce decree should be relaxed.

It is strongly recommended that no income tax return involving either the receipt or payment of alimony be completed unless the terms of the divorce decree and related agreements have been reviewed carefully in the light of the pertinent tax decisions. Even the labels "alimony" and "periodic payment" when found in the decree of the divorce court should not be accepted at face value. This might be interpreted as a warning not to set low fees in advance for the preparation of returns involving alimony.

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This paper was presented by him at the Society's Federal Tax Conference held in New York City on December 10, 1953, under the auspices of the Committee on Federal Taxation.

Applicable Code Sections

The sections of the Code directly concerned with alimony are: Section 22(k) which covers taxability of alimony to the wife (or husband); Section 23(u) which provides that alimony taxable to the wife under Section 22(k) is deductible by the husband, and, Section 171 which has to do with trusts other than those set up pursuant to the divorce decree, Section 22(k) covers the latter.

As Sections 22(k) and 23(u) are to a great extent interdependent, we can discuss them simultaneously. Please note that they are not wholly interdependent because, as pointed out in the *Seligmann* case[1], the fact that a given payment is taxable to the wife renders the same deductible to the husband, but the reverse is not true. Hence, the first line of inquiry, even though you are preparing the ex-husband's return, should be the taxability of the payment to the wife. Section 171 is of less frequent application and will be touched upon briefly toward the close.

The principal requirements in Section 22(k) for determining taxability to the wife may be summarized as follows: (1) There must have been a decree of divorce or separation and the alimony requirement must be embodied in such decree or must be set forth in writing at such a time and in such a manner as to be incident to such decree. (2) The alimony must be in discharge of a legal obligation of support arising out of the marital relationship. (3) The alimony must have been paid subsequent to the decree and the tax accounting must be on a cash basis. (4) The payments must be periodic as distinguished from a lump-sum settlement: however, if a lump-sum settlement is payable over a period of more than ten years, a maximum of one-tenth of the total sum is allowable in each year.

Typical Tax Return Problems

In an effort to reduce a complex subject to a reasonably concrete form, we shall take a straw man case covering situations of the type that are likely to occur in your practice. Let us assume that you have been engaged to prepare the return of a recently divorced husband who claims as an alimony deduction the following: cash payments to the ex-wife—$9,000; life insurance premiums — $500; rental value of $1,200 per year for his residence, use of which decree allowed to his wife. Moreover, the ex-husband informs you that he has included in his taxable income $2,000 of dividends from a trust, set up prior to his divorce, of which his wife is the beneficiary but the income from which has been taxed to him heretofore under the *Clifford* rule.

Your study of the divorce decree and related documents discloses that there is a decree of divorce which was issued in a court at Reno, Nevada, and that the alimony provision is contained in a separate agreement entered into prior to the actual entry of the decree. You ascertain from the papers (or you obtain a legal opinion if you are unclear on the point) that the decree of divorce is final and absolute as distinguished from an interlocutory type of decree[2]. Inasmuch as the alimony agreement is referred to in the decree and is stipulated by the court to be in discharge of the right of support, there is little doubt that the alimony would be considered as incident to the decree. This matter of whether or not payment is incident to the decree is a most vexing one and no hard and fast rule can be supplied. This much seems clear—the greater the interval, either before or after the decree, between the date of the commitment to pay alimony and the date of the divorce decree, the greater is the likelihood that the alimony agreed upon will be

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[1] *Seligmann* v. *Commissioner,* CCA 7, Oct. 19, 1953.

[2] *Marriner S. Eccles,* 19 TC #119; (NA) on appeal to 4th Circuit.

considered not incident to the decree. Although not pertinent to our case study it should be noted here that gratuitous payments, regardless of how motivated, are not a part of the divorce package,[3] and that the payment must be for support as distinguished from the repayment of a loan, or the payment of any other non-support obligation.[4]

You need not concern yourself with the validity of the divorce from the standpoint of it being "out of state". The Commissioner has even accorded recognition to a Mexican decree for this purpose.[5] Where there has been an annulment you should obtain a legal opinion as to whether it was an annulment *ab initio* (not a divorce) or a type of annulment which is equivalent to a divorce. When the husband and wife are separated under a decree of separate maintenance you will once again want to resort to a legal construction of their status. For purposes of simplicity we shall confine our future references to the term divorce because where the proper formalities have been observed a separation agreement is equivalent to a divorce.

You determine that, of the $9,000 in cash payments, $2,000 consisted of alimony *pendente lite* paid prior to the divorce decree. This payment fails the third test indicated above, and is subject to disallowance because the decree ordering payment of alimony *pendente lite* was not a decree of separation or divorce.[6] You also ascertain that $1,000 was for the husband's share of the wife's attorney's fee. This is likewise not deductible.[7]

An early paragraph in the alimony agreement discloses that the husband is committed to pay a total of $72,000 over a period of twelve years for the support of both wife and children. A later paragraph states that of the $12,000 per year total $4,000 is for the support of the children and $2,000 for the wife. As the $72,000 is payable over a period of more than ten years from the date of the agreement, the payments in liquidation thereof qualify without question as periodic. Stipulations concerning support of the children in the wife's custody should be read carefully. The general rule is that if no allocation is made in the agreement the entire amount of the alimony is taxed to the wife. But in at least one case[8] the Tax Court has spelled out an intent to pay directly for the support of children where the payment to the ex-wife was subject to reduction to a given figure upon her remarriage. In our example, the alimony deduction would be only $2,000 and the remainder, or $4,000, would be considered a payment by the husband for the support of the children. The husband should recoup this tax loss in part because he would be entitled to credits for dependency.

Getting back to our straw man, we now have a deduction of only $2,000 remaining from total cash payments to the wife of $9,000. You find from a further reading of the alimony agreement that certain insurance policies on the life of the husband have been assigned for the benefit of the wife and are held in escrow as security for performance of the alimony obligation of the husband. In the event that he should predecease her, the proceeds of the policy would be used to satisfy the remaining alimony obligation of the husband. If she should die first or remarry, the ex-husband would regain full ownership. Under these circumstances the premiums would not be taxable to the wife. The ex-wife would be taxable on the pre-

[3] *Peter Van Vlaanderen*, 175 F(2d) 389.
[4] *Alfons B. Landa*, 11 TCM 420.
[5] G C M 25250, 1947-2 CB 32.
[6] *George D. Wick*, 7 TC 723, aff'd per curiam, 161 F(2d) 732.
[7] *Lindsay C. Howard*, 16 TC 157, aff'd 202 F(2d) 28.
[8] *Charles B. Hicks*, 12 TCM 700.

miums only if she had obtained all of the incidents of ownership in the policy and thus meets the test of "constructive receipt".[9] Hence the husband loses on this deduction as well.

Another portion of the alimony claimed by the husband which is subject to disallowance is the rental value of the residence estimated to be worth $1,200 a year to the ex-wife.[10] This seems to be an unfair result which the husband's attorney usually can guard against in drafting an alimony agreement.

The husband has a little offsetting solace because the $2,000 per year in dividends from the *Clifford* type trust ceases to be taxable to him at the date of divorce by reason of Section 171 of the Code. The same result would apply even if the trust were revocable. Of course, to the extent the trust instrument specifies that such income is to be used for the support of minor children, it will continue to be taxed to the ex-husband.

Thus, of the alimony deduction totaling $10,700 claimed by your client, only $2,000 survives our study; in addition, $2,000 of trust income is removable from gross income, or a net loss of $6,700.

Other Tax Questions Which May Arise in the First Year

Suppose that in lieu of paying cash alimony the husband had agreed to transfer 10,000 shares of stock of the XYZ company in discharge of his obligation of support. Let us assume that such shares had a cost basis to him of $5 per share and a market value of $20 per share at the time of transfer to his ex-wife. The husband would realize capital gain of $15 per share because it would be considered that a sale had taken place in that he exchanged the shares of stock in return for the extinguishment of his support obligation.[11] Thus, a judicious selection of the assets to be transferred can be of an important consideration in planning a divorce settlement. Even though the transfer of the shares would not give rise to an alimony deduction, future dividends would be excluded from the husband's income and would be taxable to the wife.

It is well to note that payments of or out of principal may be deducted by the husband and taxed to the wife if they otherwise qualify as alimony. For instance, if the husband should purchase an annuity and meet his alimony obligations from that source, he would be taxed on 3% of the cost of the annuity but the full amount of the alimony payment would be taxable to the wife and deductible by him. This is true even though the payment to the wife would consist of both income and principal. Hence, it can be seen that we do not look to the source of the funds used to satisfy the alimony obligation in order to determine its nature from a tax standpoint. As annuities have drawbacks in alimony arrangements, this is not a recommendation of a tax saving but is merely an illustration of the high degree of vigilance required of the accountant in this field.

Gift taxes are beyond the scope of this review but they must be considered in a divorce settlement whenever property is transferred for any consideration other than a release by the wife of her right of support. A transfer to extinguish the support obligation is free from gift tax[12] and courts will not permit the Commissioner to inquire into the value of the wife's right of support in order to build up a gift tax issue.

Tax Problems in Later Years

Revisions and adjustments to alimony agreements should be made only

(Continued on page 252)

[9] *Seligmann supra.*
[10] *Pappenheimer* v. *Allen,* 164 F(2d) 428.
[11] *Mesta,* 123 F(2d) 986.
[12] *Harris,* 340 U S 106.

How to Provide for Death or Retirement of a Partner

By Wm. K. Carson, C.P.A.

When a partnership is organized, good tax planning requires that consideration be given to a number of problems which will arise on the death or retirement of a partner, and which should be covered when the partnership agreement is drawn by the attorneys. These problems can be summarized as follows: (1) the provision to be made for the continuity of the partnership following death or retirement; (2) the repayment of the partner's capital account; (3) the payment of the partner's share of the profits up to the date of death or retirement; and (4) additional payments that are frequently made to the retired partners or the estates of deceased partners.

Continuity

The reason that continuity is important in a partnership is, very frequently, that the individual partners will be reporting income on a calendar year basis, but the firm will keep its accounts on the basis of a fiscal year. Taking the most extreme case, the fiscal year may end on January 31st and a partner may die in December. If the death in December results in a termination of the partnership, there will be a doubling-up of taxable income resulting in payment of tax at higher brackets. Another adverse effect may arise where appreciated or depreciated assets are involved, and their basis would be changed by a dissolution followed by formation of a new partnership. To avoid this result, the partnership agreement should provide for continuity of the partnership in the event of death or retirement of a partner.

In a recent Revenue ruling[1] it was stated that if a partnership is actually operated on a continuous basis and the agreement so provides, the Bureau will not question the right to report on the basis of the normal fiscal year. If there are three or more partners, it is obvious that the death of one leaves at least two people to remain as partners. However, if there are only two partners, what can be done to provide for continuance of that partnership?

One possibility, in a case other than a profession, is to provide that the estate of the deceased partner will continue as a partner along with the remaining partner who is alive. This is probably impossible in a professional partnership. For instance, in the case of an accounting partnership, the rules of professional conduct provide that a partnership desiring to practice as a member of the American Institute of Accountants must have as partners only persons who are members of the

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[1] RR 144, 1953-2CB.

American Institute.[2] New members of the American Institute, in turn, must be certified public accountants. This would seem to exclude the possibility of making the estate a partner.

Repayment of Partner's Capital Account

Some provision must be made for repayment to the partner of his capital account at the time of his death or retirement. If the books of the partnership are kept on either the cash or the accrual basis, and the tax return is filed on the same basis, then the capital account for income tax purposes will be substantially identical with that shown on the books. In this case, a return of the capital shown by the books will not create a problem. If, however, the capital returned to the partner differs from the tax basis of his investment the difference must be accounted for. It would appear that the return of additional capital would be considered a gain on sale of a partnership interest and accordingly would be a capital gain.[3]

Other problems can arise from a difference between book and tax basis. Even though a partnership follows a practice of distributing all income shown by its books, there may be a gain or loss when a partner retires. For instance, the partnership may have set up a reserve which reduced income distributable to partners but did not reduce taxable income. The sum of the capital paid in by each partner, plus his share of the profits, less the profits that have been paid to him and the capital returned to him will leave a difference equal to the reserve. This should be an ordinary loss to the partner on termination of his interest.[4] Certainly, if his interest is terminated as a result of the dissolution of the firm, there has been no sale of a partnership interest which could result in the item being treated as a capital loss. If, on the other hand, a single partner retires, there might be a sale of his interest to the partnership, which would create a capital loss.

Share of Profits to Date of Death or Retirement

There is another problem, which is the payment of the partner's share of profits to the date of death or the date of retirement from the firm. The cases[5] have held that the retiring partner is subject to tax on his pro-rata share of the earnings for the period while he was a member of the firm, even though he is not a member at the termination of the fiscal year of the firm during which he withdraws. Accordingly, it is advisable to provide in a partnership agreement for a specific payment to the retired or deceased partner equal to the profits to which he would normally have been entitled. Since the person entitled to the profits will be taxed on them, an inequitable result is reached if the agreement provides for their payment to someone else.

Additional Amounts

It is not infrequent in partnership agreements, particularly those for the conduct of an accounting or legal practice, to provide for payment of additional amounts to retired or deceased partners. There are a number of reasons for this. First, in most professional partnerships, the partners are not only entrepreneurs in the business but, in addition, function much as the executives of a corporation function in our generation. As such, we might say they are entitled to a pension or similar payment so that they will not be required to work for the whole of their natural lives. We have found that works out well in our

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[2] AIA "Rules of Professional Conduct", Rule No. 1.
[3] Reg. 118, Section 39:113(a)(13)-2.
[4] See *Ad. Auriema, Inc.*, 2 TCM 778, in which petitioner failed to raise this point.
[5] *Louis Karsch*, 8 TC 1327; *Frank J. Johnson*, 9 TCM 277.

economy as a means of compensating executives of corporations, and the theory is equally applicable to a personal-service partnership.

Furthermore, one may consider that, in building up a business or in serving clients for a professional firm, the older partners have created an intangible value, which should be recognized upon death or retirement.

So there are really two different schools of thought on the question of compensating the retired partner or the estate of the deceased partner: one school of thought under which such payments are similar to a pension in the case of the person who retires, or similar to an insurance payment in the case of a partner who dies before he reaches the retirement age; the other in which the additional payments are viewed as profit on the sale of an interest in a business, much as the stock of a corporation might bring a profit when sold. With these two divergent schools of thought, it is quite obvious that different tax consequences will flow, depending on the school adopted in connection with a particular partnership agreement.

One question to be settled is the amount or method of computation of payments of this kind. There is little in writing on the subject, quite naturally, because partnership agreements are normally considered confidential documents. We have, however, the *Coates* case,[6] involving a firm of Certified Public Accountants in Hartford, Connecticut. There annual payments ranged from about 40% of previous participation in profits to about 75%, payable to the estate of a deceased partner for a period of five years. The percentages payable to the estates were larger in the case of the older partners than the younger partners. One can see, in this instance, the influence of what might be called a good-will concept in that the older partners, who had more to do with the building up the firm over a period of years, were entitled, under the terms of that agreement, to a larger percentage of the previous salary than the younger partners would be in the case of their deaths.

As contrasted to that, the agreement that was considered by the Tax Court in the *Hall*,[7] *Whitworth*,[8] and *Clowes*[9] cases, provided for annual payments of 50% of the average income of 10 preceding years, payable for a period of six years. The percentage of income was 50% irrespective of the length of service of the particular partner who died or retired.

Actually, however, the manner of setting such an amount will not determine the tax treatment either for the partnership or the recipient. There are various ways in which provisions can be made in the agreement for these payments to the retired or deceased partner. We will analyze some of those and see their results for tax purposes.

One procedure is the purchase of the withdrawing partner's interest at more than book value. A good many of the provisions in the partnership agreements of law firms, as exemplified by the various cases on this point,[10] show that that is a typical way in which the matter is handled. For instance, it can be provided that in the case of the death of a partner, his interest in the firm will be purchased by the firm and the purchase price will be paid by distributing to him or to his estate for a fixed number of years the income to which he would have been entitled had he remained as a partner in the firm.

This is a case where the partnership agreement does not provide for dis-

[6] *Charles F. Coates*, 7 TC 125.
[7] *Carol F. Hall*, 19 TC 445.
[8] *Charles R. Whitworth*, 204 F(2d) 779; cert. den.
[9] *Francis J. Clowes*, 11 TCM 1205.
[10] *Swiren* v. *Comm.*, 183 F(2d) 656, *William T. Jones, Est.* 3 TCM 97.

tributing income to the estate or to the retired partner; instead, it provides that his interest is to be purchased. The decisions[11] are unanimous in holding that where there is a purchase of an interest, regardless of the method that is employed in computing the price, it will be treated as a purchase of an interest. Thus the tax consequences are that the retired partner, or the estate of the deceased partner, receives capital gain measured by the difference between what he received and the basis of his partnership interest. On the other hand, the remaining partners in the firm are not allowed a deduction for amounts paid under such an agreement, since the amounts paid out, represent a capital expenditure for a purchase of an interest.

The second method is the one considered in the *Coates*[12] case and in the *Hall,*[13] *Clowes*[14] and *Whitworth*[15] cases. That represents the distribution of a share of profits to the retired partner, or to the estate of the deceased partner, as the case may be. In all of these cases there was a unanimous holding that, where such a method is adopted for the post-retirement or the post-death payments, the sums paid will constitute income to the retired partner or the estate, and will be a deduction to the partnership.

It should be noted, further, that in the agreements considered in these cases, the deceased partner and the retired partner did not remain as partners in the firm. The amounts that were distributed to these people were not distributed because they were partners; nevertheless, they were held to represent distributions of earnings of the firm and to be taxable as such. Why was it held that way?—Because the Tax Court, after taking into consideration all of the evidence presented concluded that it was the intent of the parties to the agreements that the additional payments were distributions of income and not an additional amount paid as purchase price of the withdrawing partner's interest.

That the Court, in determining the treatment for tax purposes of the items discussed here, looks solely to the intent of the parties is emphasized by the following quotations from the Hall[16] case:

> "The solution of the question depends upon the intent of the parties and that is to be derived from the 1936 partnership agreement."
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> "We find no language in the written agreement which would justify a conclusion that the retiring partners intended to sell their interest in the partnership to the continuing partners, or vice-versa, that the continuing partners intended to 'buy' the retiring partners' interest."

So long as the partnership intends to distribute profits, the recipient and not the partnership is taxed on the profit distributed, no matter how the amount is calculated. In *Coates*[17], the calculation was based on profits of the current year; in *Hall*[18], on profits of a prior period; and in *Hess*[19], there was a fixed amount.

In several cases there have been purchases of an interest where the price was based on future profits. In the Hill[20] case, as an example, the interest was to be valued at the profit attributable to that interest in the following two years. Nevertheless, even though the amount was not fixed

[11] *Swiren, supra*; *Jones, supra.*
[12] *Charles F. Coates, supra.*
[13] *Carol F. Hall, supra.*
[14] *Francis J. Clowes, supra.*
[15] *Rupert C. Whitworth, supra.*
[16] *Carol F. Hall, supra.*
[17] *Charles F. Coates, supra.*
[18] *Carol F. Hall, supra.*
[19] *Hess,* 12 TC 773.
[20] *Hill* vs. *Comm.,* 38 F(2d) 165.

at the time the agreement became effective, it was held that a purchase of a capital interest had been effected and that capital gain was realized by the retired or deceased partner and that no deduction was allowed to the partnership.

Since the intent of the partners is controlling, it behooves them to decide whether it is preferable to make distributions of income, or to purchase interests. Looking at the problem solely from the standpoint of income taxes, it is my thought that the former is the preferable procedure. This is because the retired partner will probably be in a lower tax bracket than the persons who continue to handle the operations of the firm. The result is that there is actually a reduction in tax of the members of partnership below the tax which would be payable if all of the income were paid to active partners. However, if a capital interest is purchased, the continuing partners pay tax on the entire income, and there is a 25% tax on the capital gain to the retired or deceased partner. Accordingly the tax is increased rather than decreased.

Tax Problems of Separation and Divorce

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after approval by a court which retains jurisdiction of the divorce. This step is necessary so as to maintain the status of incident to a decree. It has been held that a lump sum payment pursuant to a retroactive increase may nonetheless qualify as periodic alimony.[13]

Deficiencies in alimony create their own special problems. Payments made by the ex-husband in respect of arrears qualify as periodic alimony if they would have so qualified if made on time.[14] Section 22(k) specifies that where a portion of the payment is to be set aside for the support of the children any deficiency in payments must first be applied in reduction of the wife's share, thus decreasing the alimony deduction to the husband.

The estate of a deceased husband is entitled to deduct alimony and the ex-wife is taxable thereon[15] where the alimony obigation survives the husband's death.[16] The commuted value of such a debt should have been deducted for estate tax purposes by the estate of the ex-husband.[17]

The alimony provisions have been a prolific source of litigation. As we have noted above, these disputes in large part have stemmed from pre-1942 agreements. Attorneys charged with the responsibility of drafting alimony terms may feel disgruntled because the courts have been slow in developing fundamental rules on which they can place full reliance. The House Ways and Means Committee is reported to have approved a provision for the 1954 amendments which would relax the rigid requirement with respect to the existence of a court decree of divorce or separation. This should at least bring the alimony provisions up to date, inasmuch as it recognizes that income splitting is now permitted to married couples. For the other phases of the alimony sections it might prove wiser to permit the present flood of litigation to run its course and thus build up a body of authoritative case law than to run the risk of starting another lengthy period of judicial construction.

13 *E. B. Gale,* 13 TC 661, aff'd 191 F(2d) 79.
14 *Jane C. Grant,* 18 TC 1013.
15 *Laughlin's Estate,* 167 F(2d) 828.
16 Section 171(b).
17 *Estate of Pompeo M. Maresi,* 6 TC 582, aff'd 156 F(2d) 929.

How to Buy Out a Stockholder

By Henry T. Kirkebye, C.P.A.

What is the tax effect of a transaction which involves the buying out of a stockholder? Ordinarily a stockholder is free to sell his investment in any way he sees fit, and at any price. Such a sale will result in a gain or loss to such stockholder, measured by the difference between his basis and the proceeds received therefor. This will be a long-term or short-term capital gain or loss, depending upon his holding period.

My paper is more related to the situation of a stockholder in a small or close corporation; that is, where there are only a few stockholders. In such cases there are several reasons which often make it desirable or necessary to buy out a stockholder, such as the retirement of an active stockholder, illness, financial difficulties, disagreement, or death.

Buy and Sell Agreements

It is often the desire of the stockholders in a close corporation, because of their close corporation, that they prevent outsiders from coming into the business and, therefore, agreements commonly known as "buy and sell agreements" are entered into among themselves, which place certain restrictions on the disposition of the stock. These agreements cover the case of a stockholder who wishes to sell, or provides for disposition of his stock upon his death. The usual requirements call for an option to purchase on the part of the other stockholders, first on a pro rata basis, then otherwise. These options usually have a time limit, say maybe of thirty, sixty or ninety days, and in some cases even a year. If the options are not exercised, then sometimes a further option is extended to the corporation to buy-in the stock. This, too, may have a limitation as to time. If neither option is exercised, then the stockholder, his fiduciary or heir, is free to sell the stock in any manner he sees fit. Usually the existence of an agreement is evidenced by an endorsement on the stock certificates.

Some agreements impose an absolute obligation to buy on the part of the stockholders. This can be done and is an enforceable contract. Sometimes there is an absolute obligation for the corporation to buy; but this must be carefully watched in that a corporation cannot be bound unless it is in a position to buy or redeem the stock in accordance with the prevailing statutory law of the State of incorporation. As you probably know, under New York law a corporation can purchase its own stock only providing it has sufficient surplus.

Value of Stock

A very important factor in these agreements is the fixing of a value for the stock. The agreement should definitely set forth a fixed amount, or a basis for determining a value, with provisions for making periodical changes. Most often the change is made annually; but in some instances shorter periods may be preferable. In many instances book value is used as a

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basis. Book value, however, might not be a very good indication of an equitable or fair value. For instance, there may be a considerable difference in the market value of underlying assets of a corporation as compared with the value shown on the books. For example, take inventory — inventory might be reported on the books at cost, or lower of cost or market, or even on the "lifo" method; whereas the current realizable value may be considerably in excess thereof.

Another good example of extreme differences in value is often found in connection with fixed assets. The real value of land, buildings, machinery and equipment is often greatly in excess of book value. The market values of other items, such as accounts receivable, patents or investments may differ from book values. Prepaid expenses, deferred income, liabilities, claims, reserves, suits, etc. must also be considered. This country is noted for its frequent revisions of values due to its growth and fluctuating economic trends. Sometimes these trends are called "inflation" or "deflation", but we all realize, of course, that changing values resulting therefrom are not usually expressed on the books of a company.

Another very important item which causes many headaches is the matter of good will. Often there is considerable good will value which is attached to a corporation but which is not expressed on its books. Many times this item may be overlooked or deliberately omitted. How this is to be treated in an agreement must be decided and based on the facts peculiar to each situation. Fixed values or formulas may be used. The federal formula usually is an allowance of a rate of return on net worth and the capitalization of excess earnings as good will; while the New York rule usually is multiplying the average net profits of a number of years by a number of years of purchase.

Tax Aspect of Fixed Value

Now what is the relationship of an agreed value to the tax picture? We are principally concerned with value either in the computation of a gain or loss, or as a value upon which estate and inheritance taxes apply. There have been many cases in connection with values fixed by restrictive agreements, and the courts have blown hot and cold as to whether such restrictive values fix a definite fair market value for tax purposes.

At this time it may be of interest to note that only under date of August 17, 1953, the Treasury Department issued Ruling 157 and gave a set of facts based on a court decision whereby a decedent and another taxpayer each held 50% of a corporation's stock; and in accordance with the by-laws of the corporation (which again is a manner of a restrictive agreement), after the death of either stockholder the Board of Directors had a thirty-day option to purchase such stock at a price which would reflect fair value exclusive of good will. It was held that regardless of this agreement, the Commissioner, for federal estate tax purposes, would not be precluded from evaluating the shareholder's interest to include good will. The authority cited for this ruling affecting the stock of a corporation was the *Estate of George Marshall Trammel,* which involved a partnership; but the ruling, while distinguishing these two cases, said "that distinction is not deemed material." The correctness of this ruling is open to question.

Under date of September 14, 1953, the Treasury Department issued Ruling 189 citing, among other authorities, the aforementioned Ruling 157, holding that restrictive agreements providing that an owner of corporate shares must first offer them to certain interested individuals at a fixed price or a price ascertainable by application of a particular formula, are not binding upon the Commissioner in deter-

mining valuations for gift tax purposes. There may be some merit to this contention in respect of gift taxes; but I feel that when the Treasury Department determines a value for estate tax purposes greatly in excess of what the deceased's estate can ultimately receive, it is stepping out of the bounds of reality.

Of course, in the case of a death, if the stock is sold within a year of decedent's death the proceeds could be the value subject to estate taxes if the fiduciary elects to be taxed under the optional method. As you know, for federal estate tax purposes the gross estate is based on fair market value as of date of death; or, if an election is exercised, at the values one year from date of death of those assets still in the estate, plus the realized values of the assets disposed of during that period. Thus, the exercise of such an election would make the question of fair market value at date of death academic; but it does seem strange that the Commissioner could hold that the value at date of death might be far in excess of the value fixed by this agreement and yet have to accept that value because of a closed transaction after the date of death. This optional method does not hold true in respect of some State inheritance taxes. I wish to repeat here that while these restrictive agreements are originally and mainly designed for purposes of the stockholders themselves, they are not at all times binding upon the Treasury Department and the courts in connection with tax purposes. I believe the courts, however, place considerable weight on such agreements and they are an important factor to be considered. I know of certain instances where for estate tax purposes I could determine that the fair market value of the stock at date of decedent's death was considerably less than the amount of an agreed value for repurchase; but there is no question in my mind but that the Treasury Department in that case would hold that the higher agreement value was the fair market value.

Another problem in connection with the fulfillment of these restrictive agreements is the matter of payment in the event of a sale of stock between living stockholders. This can be arranged for either by lump-sum payment, or by installment arrangements. You all know, of course, the advantages or disadvantages taxwise of reporting profits on an installment basis. If the corporation is the purchaser, steps should be taken to see that the redemption is a complete transaction within one taxable year.

Certain financial considerations necessitate arrangements for providing funds for the purchase of stock. This is ofttimes done through insurance. Insurance can be arranged by a corporation and, upon the death of a stockholder, the proceeds thereof payable to the corporation can be used to purchase the stock. This has the advantage of creating a surplus from which the stock can be purchased, as well as the funds. As you know, the premiums on such insurance policies are not deductible by the corporation; but neither are the proceeds regarded as taxable income. There is a question as to whether the amount of such proceeds going into the coffers of a corporation would tend to increase the value of the stock for tax purposes. Some cases have so held. This, of course, applies only in case of death.

In connection with insurance I might give an example of a recent case which came to my attention. Three stockholders are about to enter into a buy and sell agreement. A value is being fixed which represents a one-third interest in the net worth of the corporation. This value is to be changed each year by agreement after receipt of the auditor's report. It so happens that the net worth of this corporation is equivalent to the fair market value of the underlying assets. The corporation, however, has three insurance policies on these stock-

holders, it being the intention to use the proceeds thereof towards the acquisition of the stock of a deceased stockholder. Under the terms of the agreement as contemplated, the deceased stockholder would not share in any of the increment of the proceeds over the cash surrender value of the insurance policy on his life. It is true that the annual established value will take into consideration the cash surrender value of the policy; but it overlooks entirely the matter of the proceeds. A suggestion was made, therefore, to qualify the agreement — that in the case of death of a stockholder, the value should be the stated value plus one-third of the difference between the cash surrender value and the insurance proceeds.

Redemption of Stock

I shall now get back to the tax treatment of the proceeds of sale or redemption by a corporation. Ordinarily there is a return of capital where all shares of a stockholder are sold or redeemed, and a gain or loss may result. In the case of redemption by a corporation, however, attention is called to Section 115(g) of the Internal Revenue Code, which reads as follows:

> "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

I wish to bring out that this paragraph says "in such time and in such manner." There have been numerous cases regarding this and it is of extreme importance taxwise.

The Regulations state that the question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend, depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution. On the other hand, a cancellation or redemption by a corporation of *all* of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. I emphasize the redemption of *all* of the stock of a particular shareholder. There is a case where two families held stock in a corporation for a period of years. One of the stockholders died and the estate needed some money to pay off debts. The probate judge suggested that the estate sell the requisite number of shares of the corporation to realize an amount sufficient to pay the debts, rather than have the corporation declare a dividend which would belong to the heirs. The corporation agreed to this and a specified number of shares at par value were purchased from *both* shareholders and were immediately cancelled. The courts held that this purchase was a redemption essentially equivalent to the distribution of a taxable dividend. Two of the factors considered important by the court were the pro rata distribution and that initiative for distribution came from a stockholder who needed cash. It is noted, however, that in this case all the shareholders surrendered a proportionate amount of their stock. There probably would have been no question if all of the stock of the deceased stockholder only had been acquired.

In another case decided in the United States Circuit Court of Appeals in 1951, the issue was that a corporation had acquired from two or three principal stockholders a certain proportionate amount of their stock; and it was held that this distribution was the equivalent of a taxable dis-

tribution. One of the factors considered by the court again was that the initiative for distribution came from the majority stockholders needing money. It was also noted in this case that this redemption was not even pro rata among all stockholders. These cases had nothing to do with a buy and sell agreement but have been mentioned to show the consequences of a distribution or redemption by a corporation. This points up that a buy and sell agreement cannot provide for pro rata redemptions without the great danger of taxable distributions. Such agreements should limit the redemption to only the stock of the deceased or selling stockholder. Of course, complete or partial liquidation of the corporation will not result in a taxable dividend.

An acquisition of stock of an issuing company through the use of a controlled corporation may be regarded as a taxable distribution by reason of Section 115(g) (2), added to the Internal Revenue Code by the Revenue Act of 1951. Controlled means ownership of stock directly or indirectly of 50% or more of the voting stock, or 50% or more of the total value of all classes of stock. Naturally, this is such a new section of the Code that there have been no cases in connection therewith; but I expect there will be many.

I mentioned before that arrangements could be made for payment of the stock on an installment basis. This may be dangerous from the point of view of a corporation entering into such agreement, in that installment payments might not be regarded as a complete redemption of all of the stock of a taxpayer in respect to one year. If all the stock is surrendered at time of redemption it might cover the complete redemption part; but partial surrenders at time of payments might not be so considered.

There is a section of the Internal Revenue Code, namely, Section 115(g) (3), which provides in effect that there would be no determination of a taxable dividend where *a part* of the stock was acquired from an estate and the proceeds thereof are to be used to pay death taxes. This determination in respect of redemption is limited, however, to only that amount of stock which is necessary to pay the estate taxes. A further requirement for this is that the stock of the decedent must be more than 35% of the value of the gross estate of such decedent. Thus, it is possible to have a redemption of part of the stock of the corporation belonging to the estate, without the distribution being considered a taxable dividend. This does not eliminate, however, the possibility of gain or loss, if any. It is well to remember this section, as it could have a bearing on meeting certain conditions in a buy and sell agreement. I have in mind the agreement providing for the corporation to buy that amount of stock which meets the restrictions of this section, leaving the balance to be purchased by the other stockholders.

In conclusion, I repeat that buy and sell arrangements, which for the most part are principally designed for the benefit and protection of stockholders, nevertheless, can have tax consequences which must not be overlooked when such agreements are under consideration. Furthermore, consideration of redemption of stock on the part of corporations must be carefully reviewed to avoid substantial tax liability.

The 116th New York Certified Public Accountant Examination

November 4, 5 and 6, 1953

THEORY OF ACCOUNTS

Friday, November 6, 1953—1.30 to 5 p. m., only

This paper is intended to test the extent of your knowledge of accounting theory and your ability to apply the knowledge you have acquired. Due weight will be given to the arguments presented to support your answer to each question, even though the examiners may not agree with your conclusions.

Group I—Answer any two questions out of this group of three.

1 [20]

The following information relates to the purchase of an asset that was paid for by a trade-in of an old asset and the balance in cash:

List price of new asset	$10,000
Cash payment	5,800
Cost of old asset	8,000
Depreciation reserve—old asset	5,000
Second-hand market value—old asset	3,600

a You are to prepare journal entries to show *three* different methods of recording the transaction.

b Following each entry give an explanation of the reasoning behind that method of recording and indicate the circumstances in which it might be appropriate.

2 [20]

Item A—Corporation X manufactures at a finished cost of $20.00 per unit and sells to Corporation Y @ $25.00 per unit. Corporation Y leaves its inventory of Item A in the warehouse of Corporation X, withdrawing only as needed and pays to Corporation X storage at the rate of 50¢ per unit per month. The quantity in the inventory of Corporation Y at December 31 was purchased six months previously. Corporation Y resells at $40.00 F.O.B. shipping point which is the same price at which Corporation X sells to others.

Item B—Corporation X owns and operates a mine from which Item B is extracted. The average cost of mining Item B is $5.00 per ton. The cost of the mine and development thereof is subject to depletion at the rate of $2.50 per ton. The cost of loading on freight cars averages $1.00 per ton. Corporation Y purchases from Corporation X at cost F.O.B. the mine and transports to its plant, paying freight of $1.50 per ton. Corporation X sells approximately 75% of its mined product to others at a price of $15.00 per ton F.O.B. the mine and Corporation Y sells at a substantial profit after refinement.

Item C—Corporation X buys manufacturing supplies at a price of $50.00 per unit less trade discounts of 10/10/20. A portion of the supplies purchased by Corporation X are resold to Corporation Y at a price of $41.00 F.O.B. Corporation Y's plant. The freight, paid by Corporation X, amounts to 50¢ per unit. Corporation Y does not have access to the market from which Corporation X buys.

Item D—Corporation X manufactures this item at the average cost of $29.00 per unit and sells its total output to Corporation Y @ $35.00 per unit, F.O.B. Corporation X's plant under terms of a firm contract. The freight amounts to $2.00 per unit. The amount obtainable from Corporation X is only about 50% of the quantity required by Corporation Y. The balance of Corporation Y's requirements are obtained from other sources at a price of $32.50 per unit, F.O.B. Y's plant. Y resells this item at a price which yields $34.00 per unit after allowing for sales and handling expense.

Item E—Corporation X manufactures at a cost of $6.00 per unit and sells to Corporation Y and others @ $5.00 per unit F.O.B. Corporation X's plant. The freight to Y's plant amounts to 75¢ per unit. Corporation Y processes this item and sells at a profit.

Required: Consider that there were 10 units of each of the five items in the inventory of *each corporation* at the end of their concurrent fiscal years. You are to show the proper valuation at the lower of cost or market for inventory purposes in the financial statements, and to explain in connection with each valuation the reason for using it. Answer for each item separately.

a In the financial statements of Corporation X and Corporation Y assuming there is no relation between the two corporations.

b In the consolidated financial statements assuming Corporation Y is a wholly owned subsidiary of Corporation X.

3 [20]

a Explain the basic difference in the method of accounting for joint products and foı by-products

b State the conditions under which an item should be treated as a by-product rather than as a joint product.

c Explain the two principal methods of assigning joint costs to the joint products and state the circumstances under which each would be appropriate.

Group II—Answer any five questions out of this group of seven.

4 [12]

a Define the following terms as used in relation to depreciation of fixed assets: (1) unit basis, (2) group basis, (3) composite basis.

b Explain how retirements are handled under each of the above three bases for computing depreciation.

c Give the arguments for and against the three bases.

5 [12]

A manufacturing company using the LIFO method for valuation of raw materials applies a write-down of certain materials to reduce their value to market which is lower than the LIFO basis.

a Give arguments for and against this write-down.

b Is the write-down deductible for Federal income taxes?

c Assuming a write-down is made, state how it should be treated in financial statements issued to stockholders.

6 [12]

Your client, a retailer, has recently taken occupancy of pıoperty under the terms of a ten-year renewable lease. In this connection, you note the following items of information:

a Annual rental under the lease is $12,000.

b At a cost of $60,000 your client has made leasehold improvements that have an estimated life of 30 years.

c The lease calls for removal of the improvements at the expiration of the lease. It is estimated that this will cost $15,000 net of salvage.

Required: Describe fully the treatment of *each* of the above items in the financial statements. Justify the treatments you describe.

7 [12]

a State the rule followed by a company in converting foreign currency into U. S. dollars on (1) fixed assets of branches in foreign countries, (2) inventory of merchandise bought by the foreign branch in that country.

b If your basis of conversion differs as to the two items listed in *a*, explain why there is such difference, including a discussion of the accounting principles that are involved.

8 [12]

Consolidated statements are frequently presented for a parent company and its subsidiary or subsidiaries. There are a number of reasons for their use in presenting financial data. However, such statements are subject to several limitations in the usual situation. You are to state and explain the limitations of consolidated statements.

9 [12]

State and explain the considerations involved in deciding whether a general contractor should take up revenue on the "completed contracts" basis or on the "percentage of completion" basis.

10 [12]

What conditions must exist or what requirements must be met to make the following changes in accounting methods of reporting income under the Federal income tax regulations: (*a*) from cost to retail method, (*b*) from accrual to installment method, (*c*) from "cost or market, if lower" to "LIFO" valuation method?

COMMERCIAL LAW

Friday, November 6, 1953—9 a. m. to 12.30 p. m. only

Reasons must be stated for each answer except for objective type questions; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.

Group I—Answer all questions in this group.

1 [10]

a Under what circumstances may an action for damages arising out of non-performance of a sales agreement be brought by (1) the buyer against the seller, (2) the seller against the buyer?

b Where there is a breach of warranty by the seller of goods, what are the various remedies available to the buyer?

c Where the buyer has selected and has been granted a remedy for breach of warranty, may he seek thereafter to enforce one of the other remedies?

d State what is the measure of normal damages for a seller's breach of warranty.

2 [10]

a Define tender of performance of a contract.

b Dan owes several debts to Clem. Dan pays a sum of money on account and asks at the time of payment that it be applied to a specific debt. Is Clem obligated to do so? Explain.

c Where a part payment is made on an interest-bearing debt, how is the sum applied as between principal due and overdue interest (1) where the debtor directs application to the principal, (2) where the debtor makes no statement as to application?

3 [10]

a (1) What is the effect of knowingly making a promissory note payable to a fictitious person?

(2) By whom may a bill of exchange be protested?

(3) In a promissory note how does an indorsement in blank differ in form and legal effect from a special indorsement?

b D drew a sight draft on P, payable to the order of X. X presented the draft to P, who writes on it, "Accepted—payable in ten days, P." X did not notify D. At the expiration of ten days, P did not pay the draft. X then sues D.

(1) Is D liable? Why?

(2) What are the rights and liabilities of the holder, X, and the drawer, D, in this situation?

4 [10]

A, B and C were partners in the drug business. Under the partnership articles, A was to act only as manager while B and C were to purchase supplies for the firm. A and B had contributed $10,000 each to the capital of the firm, while C contributed the store building in which the business was carried on, retaining the title in his own name. Answer the following questions, using the Uniform Partnership Act as the basis for your answers:

a If nothing is said in the partnership agreement as to sharing profits, how much would A, B and C each receive out of a $9,000 profit earned at the end of the first year? Explain.

b If A should contract to buy drug supplies from X, a wholesaler, making the contract in the firm name, can the firm be held for the contract? Why?

c If B and C should decide, against A's wish, that the firm should open a hardware store in a distant town, may they do so? Why?

d If C should sell and convey in his own name the store building to T, who knew nothing of the partnership's interest in the building, could T obtain the title to the building? Why?

e Could C and B prevent A from assigning his interest in the partnership to Q? Explain.

5 [10]

a What are "blue sky" laws?

b Name *five* of the more common rights and privileges of a stockholder of a corporation.

c Explain the right of stockholders to acquire new stock (1) where the stock is held as "Treasury Stock," (2) where unissued stock is to be sold.

d What are the essential records that should be kept by a corporation?

Group II—Answer any five questions in this group.

6 [10]

a Jones and Burns, who are partners, use several automobiles in their business. Also, each partner individually owns other cars. Together they call on Allen, a second-hand car dealer, who knows the facts, and they direct him to "sell all our automobiles."

What is Allen's authority as to the partnership cars and the cars individually owned by Jones and Burns? Explain.

b Peters authorizes and directs Smith to purchase 100,000 bushels of wheat and to charter a steamer on which to ship it. Later, and before Smith has acted, Peters telegraphs Smith not to buy the wheat.

Does Smith still have authority to charter the steamer? Explain.

c Albert shipped to Burt 100 bales of hops. The agreement specified that they were to be of a certain grade. Upon examination by Burt it was claimed that they were not of that grade. The sales agent of Albert who made the sale to Burt agreed to relieve Burt from liability and to have the hops shipped elsewhere. This was done and they were sold at a price less than that to be paid by Burt. Albert refused to accede to the agent's acts and sued Burt for the amount of his loss.

Should Albert recover in view of the agent's agreement? Explain.

d On misrepresentation of being Paul's agent, George contracts to buy goods, intending to purchase for himself but using Paul's name to obtain credit. This comes to Paul's knowledge and, as the contract is very advantageous, Paul wishes to obtain it.

Can Paul obtain the contract? Explain.

7 [10]

a State the important respects in which the legal status of a general partnership usually differs from that of a corporation. Give *at least four*.

b What does the term "person" include as used in the Uniform Partnership Act?

c On dissolution of a partnership, one or more partners exercise authority as to winding up the business. In what special capacity do these partners act?

d In the voluntary dissolution of a limited partnership, in what order are the remaining assets distributed to partners after all liabilities to creditors have been paid?

8 [10]

a State the doctrine of substantial performance of contracts.

b Define the following terms: (1) receipt, (2) release, (3) mutual release, (4) general release.

c On what grounds can the finality of a release be attacked?

d Distinguish between general and special damages for breach of a contract.

e What are liquidated damages?

9 [10]

a Define a contract of suretyship and a contract of indemnity.

b What is meant by a "surety's right of contribution"? Explain how the amount of contribution is determined.

c Where Able and Baker are sureties on the bond of an insolvent principal and Able, without knowing of the existence of Baker as a surety, is compelled to pay the entire debt, what remedy, if any, has he against Baker? Explain.

10 [10]

a In order that a person may acquire title to real estate by adverse possession, what must he have done with respect to the property?

b Name and describe the four major types of tenancies between landlord and tenant.

c What is the difference between a quit claim deed and a warranty deed?

11 [10]

On your paper you are to list the numbers 1 through 10. Opposite each number you are to write the word *true* if the corresponding statement is true or the word *false* if the corresponding statement is not true. Your answers should be based on the Uniform Negotiable Instruments Law. Grade will be computed on the number of correct answers. No reasons need be given.

(1) A negotiable instrument must be dated.

(2) A person may acquire the rights of a holder in due course of a negotiable instrument without being a holder in due course.

(3) An accommodation party is liable to the party accommodated.

(4) In the absence of special agreement, indorsers are liable prima facie to one another in the order in which they indorse.

(5) A holder may strike out any indorsement not necessary to his title.

(6) Lack of consideration in the original making of a note is a defense that can be maintained against a holder in due course.

(7) Forgery in the original making of a note is a defense that can be maintained against a holder in due course.

(8) Incapacity to contract is a defense that can be maintained against a holder in due course.

(9) A qualified indorser undertakes that the instrument will be paid at maturity.

(10) A general indorser warrants that all prior parties had capacity to contract.

12 [10]

On your paper you are to write the numbers 1 through 10. Opposite each number you are to write the word *true* if the statement is true or the word *false* if the statement is not true. Base your answers on the most general rule of law. Grade will be computed on the number of correct answers. No reasons need be given.

(1) A written promise can be enforced as a contract without consideration being received in return.

(2) A contract to sell a watch worth $100 for $75 is unenforcible for inadequacy of consideration.

(3) A written promise by a debtor to pay a debt barred by the statute of limitations is enforcible without new consideration.

(4) A promise by the promissor to perform an act that the promissor is already legally bound to do offers sufficient consideration for a new and different contract.

(5) A claim for money, the amount of which is not in dispute, may be discharged by the payment of any amount upon which the parties agree.

Data for questions 6-10

A owned a house and lot which he leased to B. B erected a two-car garage at the rear of the lot and placed a sign "B's Woodcraft Shop" over the door. In the garage B put in a work bench, an electric motor, a lathe and electric lights. B also put in a radiator and laid pipes connecting it with the heating plant in the house and also laid down a cement walk to the house.

A later mortgaged the premises to C. One year later, as a result of A's failure to make payments on the mortgage, C began foreclosure proceedings. Assuming B's lease is about to end, indicate whether *each* of the following five statements is *true* or *false*.

(6) B may remove the garage from the premises.
(7) B may not remove his lathe from the garage.
(8) B may remove his electric motor from the garage.
(9) B may not remove the work bench from the garage.
(10) C has a right to demand that the cement walk be left in.

AUDITING

Thursday, November 5, 1953—9 a. m. to 12.30 p. m., only

Write your answer clearly and concisely, being particular to express your own knowledge, for on that is based the rating. Avoid quotations from authors. Credit will be allowed not only for accuracy of answer but also for technic.

Answer any eight of these nine questions.

1 [12½]

On May 15, 1952, you are engaged to make an audit of a corporation whose records you have not previously examined. Your client is a retail coal dealer with a fiscal year ending May 31. Perpetual inventory records are in use and sales are accumulated both as to dollar amount and tonnage for each type of coal sold. A part of the coal on hand at May 31, 1952, is stored in loading bins while the remainder is piled in the open or contained in railroad cars.

a List audit procedures to be followed in the verification of inventories at May 31, 1952.

b Assuming that no audit had been made at May 31, 1951, suggest procedures to test the credibility of cost of goods sold.

2 [12½]

The independent certified public accountant should not express the opinion that the financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, (1) when his exceptions are such as to negative the opinion, or (2) when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole.

a Describe fully a situation in which an auditor can not express an opinion because his exceptions are such as to negative the opinion. Give a full explanation of the criteria applicable in making this decision.

b Describe fully a situation in which an auditor can not express an opinion because his examination has been less in scope than he considers necessary. Explain why you think no opinion should be expressed in the situation which you describe.

c Draft an appropriate short-form audit report which an auditor might submit in situation given in your answer to *b*.

3 [12½]

a In 1952 your client, the T.E.L. Video Corporation, was licensed to manufacture a patented type of radio tube. The licensing agreement called for royalty payments of ten cents for each tube manufactured. What procedures would you follow in connection with your regular annual audit as of December 31, 1952, to satisfy yourself that the liability for royalties is correctly stated?

b After your audit of the T.E.L. Video Corporation was completed, they asked you to prepare a certified report for the owner of the patent on the radio tube, covering therein your findings as to Royalty payable. Prepare the report that you would submit. (You may make an assumption as to any figures, if you wish to use them.)

4 [12½]

X Corporation is a medium-sized manufacturer of equipment and has a fiscal year ending April 30th. The useful life of its product is rarely over ten years. New models are introduced each year. An inventory of repair parts is maintained and a price list of parts

is published annually that shows prices to dealers and retail sales prices. These list prices are influenced by competitive market quotations.

Perpetual inventory records of repair parts are maintained in quantities and an annual physical inventory is taken. For statement purposes the inventory is extended at current list prices to dealers and reduced to cost by application of a computed per cent.

You are the senior in charge of the annual audit of X Corporation as of April 30, 1953. When the audit is finished you know your work will be reviewed and you will be questioned about the problems in connection with each phase of the audit. In connection with the audit of the repair parts inventory, for example, you will be asked if the inventory is included in the inventory certificate obtained from the client.

In connection with the audit of the repair parts inventory, what additional questions might you expect to be asked when your work is reviewed?

5 [12½]

The Irving Manufacturing Company uses a system of shop orders in its plant. This system includes a series of orders for construction and installation of fixed assets, another series for retirement of assets and a third series for maintenance work. There are "standing order" numbers for minor repetitive maintenance items and special orders for unusual or major maintenance items.

In connection with a regular annual audit of the Irving Manufacturing Company prepare a program for work to be done on the maintenance orders. Assume that there appears to be reasonable internal control in the company. Prepare your program to avoid doing any more work than is necessary to meet acceptable auditing standards and explain the purpose or objective of each of your proposed steps.

6 [12½]

James Thomas opened a retail shoe store in 1949. The business was incorporated under the name of Thomas Shoe Fair, Inc. Toward the end of 1952 the corporation made purchases far in excess of those previously made. Early in 1953 it filed a petition in bankruptcy showing very little inventory and cash but large accounts payable for purchases. Thomas asserts that the shoes were sold at very low prices to attract new business and that he unwittingly outran his resources. A weekly entry of cash receipts in the check book was his only record of sales and the creditors suspect fraud. You have been retained by the creditors to investigate.

a Outline the procedures you would follow in your investigation.

b Indicate the general contents of your report to the creditors.

7 [12½]

a In what ways can the use of cash registers contribute to the effectiveness of internal control over receipts from cash sales? Explain.

b The general ledger of the XY Manufacturing Company contains a Payroll clearing account. Debits to the account originate in the payroll section of the factory accounting office. Credits to the account originate in the cost distribution section. The company does not use standard or estimated costs. On the assumption there is effective internal control over payrolls you are to:

(1) State the information needed by the payroll section and indicate the source of this information.

(2) State the information needed by the cost distribution section and the source of the information.

(3) State the principal controls over payroll in the system as you have described it.

8 [12½]

You are assigned to the regular annual audit of a Savings and Loan Association. In these associations the members' "savings accounts" constitute the principal source of capital funds. Members sometimes obtain loans from the association, pledging their savings accounts as sole collateral.

Prepare in outline form a program for the audit of such loans on savings accounts.

9 [12½]

List and give a brief description of the form and content of the principal exhibits or statements needed in a report covering the audit of a municipality.

PRACTICAL ACCOUNTING—Part I

Wednesday, November 4, 1953—1.30 to 6 p. m., only

The Practical Accounting paper consists of part I and part II.

Consider carefully each requirement of each problem. Designate each solution by number. Consider technic and neatness as carefully as mathematics.

Begin each answer on a separate answer sheet. Answers are to be written on one side of the paper only. Working papers (but not statements) may be in pencil. All other papers are to be written in ink. Write your answers legibly to insure credit to which you may be entitled. The use of a slide rule is permitted.

Answers must be written on paper supplied to the candidate by the official in charge of the examination. Answers written on other than such paper shall not be accepted by the Board.

Solve problems 1 and 2 and any two of the last three problems.

1 [15]

Russel Waters established a retail business in 1950. Early in 1953 he entered into negotiations with John Jones with a view to forming a partnership. You have been asked by the two men to audit Waters' books for the past three years.

The profits per client's statements were as follows:

	Year Ending 12/31		
	1950	*1951*	*1952*
Profit	$9,023	$10,109	$10,340

During the audit, you found the following:

	Year Ending 12/31		
ITEM	*1950*	*1951*	*1952*
Omissions from the books:			
A Accrued expenses at end of year	$2,160	$2,904	$4,624
B Accrued income at end of year	200	—	—
C Prepaid expenses at end of year	902	1,210	1,406
D Deferred income at end of year	—	610	—
Goods in transit at end of year omitted from inventory:			
E For which purchase entry had been made	—	2,610	—
F For which purchase entry had not been made	—	—	1,710
Other points requiring consideration:			
G Depreciation of equipment had been recorded monthly by a charge to expense and a credit to an allowance for depreciation account at a blanket rate of 1% of end of month balances of equipment accounts. However, the sale during December 1951 of certain equipment was entered as a debit to cash and a credit to the asset account for the sale price of	—	5,000	—
(This equipment was purchased in July 1950 at a cost of $6,000.)			

	Year Ending 12/31		
	1950	1951	1952
H No allowance had been set up for uncollectible accounts. It is decided to set up one for the estimated probable losses as of December 31, 1952, for:			
1951 accounts	—	—	$ 700
1952 accounts	—	—	1,500
and to correct the charge against each year so that it will show the losses (actual and estimated) relating to that year's sales.			
Accounts had been written off to expense as follows:			
1950 accounts	$1,000	$1,200	—
1951 accounts	—	400	2,000
1952 accounts	—	—	1,600

Instructions: Following is a series of multiple-choice questions based upon the foregoing data. You are to select the *one* correct answer for each question. Assume that accruals of any year are reflected in the cash transactions of the following year and that prepayments of any year are reflected in the revenue or expense accounts of the following year.

a Indicate your choice on the answer sheet provided by placing an X in the correct column to show the effect:

(1) On 1950 profit of the omission of accrued expenses as of the end of 1950.

(2) On 1951 profit of the omission of accrued expenses as of the end of 1950.

(3) On 1952 profit of the omission of accrued expenses as of the end of 1950.

(4) On 1951 profit of the omission of accrued expenses as of the end of 1950 and 1951, when considered together.

(5) On 1950 profit of the omission of accrued income at the end of 1950.

(6) On 1951 profit of the omission of accrued income at the end of 1950.

(7) On 1952 profit of the omission of accrued income at the end of 1950.

(8) On 1950 profit of the omission of prepaid expenses at the end of 1950.

(9) On 1951 profit of the omission of prepaid expenses at the end of 1950.

(10) On 1950 profit of the omission of prepaid expenses at the end of 1951.

(11) On 1952 profit of the omission of prepaid expenses at the end of 1951 and 1952, when considered together.

(12) On 1951 profit of the omission of deferred income at the end of 1951.

(13) On 1952 profit of the omission of deferred income at the end of 1951.

(14) On 1951 profit of the omission of goods in transit at the end of 1951.

(15) On 1952 profit of the omission of goods in transit at the end of 1951.

(16) On 1952 profit of the omission of goods in transit at the end of 1952.

(17) On 1952 profit of the omission of goods in transit at the end of 1951 and 1952, when considered together.

(18) On 1951 profit of the error in recording sale of asset.

(19) On 1952 profit of the error in recording sale of asset.

(20) On the cumulative three-year profits of the failure to use the "reserve" method in the yearly charges for uncollectible accounts.

b Indicate the effect, if any, of the change from the charge-off to the reserve method as outlined in item *H*. Did the *change* decrease the reported profit, increase the reported profit, or have no effect on the reported profit (1) for the year 1950? (2) for the year 1951? (3) for the year 1952?

c In the schedule provided on your answer sheet, compute the net adjustment of profit for the year 1951, filling in the *net* amount of the adjustment necessary for each item (*A* through *H*) in the problem.

d Following is the data required for solving questions (1) through (4) below.

Assuming that your adjustments do not significantly change the profit figures for the three years, compute goodwill by *each* of the following four methods,

based upon the uncorrected profits per books. (Assume net assets of $80,000 and a normal rate of return of 8%. No goodwill is on the books at present.)

Method 1—Purchase of past three years' excess profits.

Method 2—Payment equal to twice the average past excess profits.

Method 3—Difference between average past profits capitalized at 8% and present net assets.

Method 4—Capitalization of average excess profits at 25%.

(1) Goodwill computed by method 1 is (*a*) $23,072 (*b*) $10,272 (*c*) no goodwill (*d*) none of these

(2) Goodwill computed by method 2 is (*a*) $7,649 (*b*) $6,848 (*c*) $3,824.50 (*d*) none of these

(3) Goodwill computed by method 3 is (*a*) $67,720 (*b*) $42,800 (*c*) no goodwill (*d*) none of these

(4) Goodwill computed by method 4 is (*a*) $8,560 (*b*) $856 (*c*) no goodwill (*d*) none of these

2 [15]

You have been retained by a fire insurance adjustor to examine the records salvaged from a fire which almost completely destroyed the office and warehouse of A, B, and C, partners in a wholesale jobbing business.

Your report, directed to the adjustor, must include an estimate of the inventory value as of the date of the fire, January 2, 1953.

The merchandise handled by the firm is divided into three lines or classes of goods, designated as X, Y and Z. Classes X and Y each consist of a number of items that are bought and sold without change of form; Class Z consists of one item only for which raw material is bought and put through a manufacturing process.

The following records and data are found to be available:

(1) Duplicate sales invoices and credit memos, the totals of which are as follows:

	Sales	Credit Memos
Year 1950	$122,785	$6,585
Year 1951	110,942	7,582
Year 1952	87,451	4,160

A check of the numbers discloses that approximately 9% of the duplicate sales invoices for 1952 are missing.

(2) Duplicate bank deposit slips without any missing dates:

Year 1950	$108,066
Year 1951	96,008
Year 1952	91,150

Duplicate bank deposit slips were found to represent receipts from accounts receivable and cash sales only. You learn on inquiry that the partnership has made a practice of paying some expenses out of cash receipts not deposited. The amount of such payments can not be determined.

(3) Purchase invoice files, accompanied by adding machine tapes purporting to show the total purchases for each year, with totals as follows:

Year 1950	$131,616
Year 1951	117,935
Year 1952	76,158

(4) Inventory sheets, taken by the mangement as of January 1, 1950:

Class X	$58,500
Class Y	28,080
Class Z—raw materials	17,550
—finished, 4/7 of which is raw material	16,380

The management stated that about 17% was added to the cost of merchandise and raw materials in the 1950 inventory to cover freight and handling. A comparison of some of the inventory prices with purchase invoices at about the date of the inventory confirmed this statement. You find, however, that *2% of net purchases* is sufficient to cover freight and handling into the warehouse and allow this percentage in *all cost computations.*

You ascertain also that 17% has been added to the cost of direct labor and overhead in the January 1, 1950, finished goods inventory, and that the overhead is 50% of the direct labor.

(5) Upon examination of the contents of the purchase invoice files you find that credit memos representing allowances on purchases have been listed on the adding machine tapes as invoices and included in the totals, as follows:

Year 1950	$7,548
Year 1951	7,225
Year 1952	6,120

All suppliers of merchandise and materials are circularized with a request for an itemized statement of account for the last three years, and these statements show additional credit memos in the following amounts:

Year 1950	$1,751
Year 1951	3,128
Year 1952	5,610

(6) Raw materials for Class Z are purchased in carload lots, and the invoices for the three years show total purchases of $33,000.00. You find that the shop foreman has kept a record showing that raw materials, of which the invoice cost was $34,000, have been put in process in the three years, and that the proportions of direct labor and overhead to material cost have been approximately maintained.

(7) Analysis of a considerable number of sales invoices, selected in such a way as to give a fair sample of the entire file, and comparison with the computed cost of each item, give results that are summarized as follows:

	% of Net Sales	*% Gross Profit to Net Sales*
Class X	45%	10%
Class Y	26%	15%
Class Z	29%	21%

Required: You are to prepare computation of approximate inventory at January 2, 1953, including a schedule showing separately the raw materials and finished goods in Class Z. (Do not carry out any computations farther than the nearest dollar.)

Solve two of the following three problems.

3 [10]

The partners of Sims and Company agreed to dissolve their partnership and to begin liquidation on February 1, 1953. Rowe was designated as the partner in charge of liquidation. It was agreed that distributions of cash to the partners were to be made on the last day of each month during liquidation, provided that there was sufficient cash available.

The partnership agreement provided that profits and losses were to be shared on the following basis: Quinn 20%, Rowe 30%, Sims 30% and Toth 20%. The firm's condensed balance sheet as of February 1, 1953, was as follows:

Cash	$33,440	Accounts payable	$ 7,120
Goodwill	20,000	Loan from Quinn	5,000
Other assets	44,510	Capital:	
		Quinn	8,040
		Rowe	32,160
		Sims	36,340
		Toth	9,290
	$97,950		$97,950

The liquidating transactions for February and March, other than cash distribution to partners, are summarized by months below:

	CASH	
	February	*March*
Liquidation of assets with a book value of:		
$22,020	$16,440	
14,950		$16,110
Paid liquidation expenses as incurred	2,740	2,460
Paid to creditors on account	5,910	1,210

Required: Prepare a schedule showing the total amounts of cash distributed to the partners at the end of February and March and the amounts received by each partner in each distribution. Assume that Rowe made the distributions in such a manner that eventual overpayment to any partner was precluded.

4 [10]

From the following data you are to compute the ***unit sales price*** (adjusted to the nearest full cent) at which the Howle Manufacturing Corporation must sell its only product in 1953 in order to earn a budgeted profit (before income taxes) of $60,000.

The corporation's condensed income statement for 1952 follows:

Sales (30,000 units)		$450,000
Returns, allowances and discounts		13,500
Net sales		$436,500
Cost of goods sold		306,000
Gross profit		$130,500
Selling expenses	$60,000	
Administrative expenses	30,000	90,000
Net profit (before income taxes)		$ 40,500

The budget committee has estimated the following changes in income and costs for 1953:

30% increase in number of units sold.
20% increase in material unit cost.
15% increase in direct labor cost per unit.
10% increase in production overhead cost per unit.
14% increase in selling expenses, arising from increased volume as well as from a higher price level.
7% increase in administrative expenses, reflecting anticipated higher wage and supply price levels. Any change in administrative expenses caused solely by increased sales volume are considered immaterial for the purpose of this budget.

As inventory quantities remain fairly constant, the committee considered that, for budget purposes, any change in inventory valuation can be ignored. The composition of the cost of a unit of finished product during 1952 for materials, direct labor and production overhead, respectively, was in the ratio of 3 to 2 to 1. No changes in production methods or credit policies were contemplated for 1953.

5 [10]

a Rearrange the following balance sheet of the Town of W in acceptable form for municipal reporting:

Balance Sheet—June 30, 1953

ASSETS

Current		
Cash	$ 50,000	
Taxes Receivable (including special assessments $80,000)	100,000	
Supply Inventories	10,000	
Investments of Trust Funds	30,000	$ 190,000
Fixed		
Land	$100,000	
Buildings	800,000	
Equipment	50,000	950,000
		$1,140,000

LIABILITIES

Current		
Accounts Payable		$ 10,000
Fixed		
General Obligations Bonds Payable	$350,000	
Special Assessment Bonds Payable	75,000	425,000
Fund Equities		
General Fund	$ 35,000	
Trust Funds	40,000	
Bond Fund	25,000	
Special Assessment Fund	5,000	
Capital Fund	600,000	705,000
		$1,140,000

b The Town of W, for which the balance sheet was prepared in part *a*, will use budgetary accounts. You are to prepare the balance sheet for its General Fund at the end of its first month of operation in its fiscal year starting July 1, 1953. The following events are to be considered:

(1) A budget was adopted that provided for property taxes of $210,000 for general municipal purposes and for estimated revenue from fees, etc. of $23,000. Appropriations were $180,000 for current operations, $20,000 for debt service and $35,000 for street and other capital improvements.

(2) During July purchase orders of $9,400 were placed, $3,150 of which were received and vouchered at an actual net cost of $3,078. Payroll amounting to $5,185 was vouchered and $14,000 of accounts payable were paid.

(3) The tax roll was not completed but $21,000 of 1952-53 taxes were collected, $18,350 of which were special assessments. Also, $466 of delinquent taxes and penalties were collected. These taxes had been written off and no amount was in the current budget for such collections. Miscellaneous fees collected, etc. amounted to $2,060.

(4) Inventory of supplies at the end of the month was $10,400.

PRACTICAL ACCOUNTING—Part II

Thursday, November 5, 1953—1.30 to 6 p. m., only

Solve all problems.

1 [12]

The following relates to Federal income taxes. Parts *a* and *b*, dealing with items of gross income and deductions, respectively, should be answered *true* or *false*. However, in not more than one sentence, you *may* give the reason for your conclusion where an

explanation seems appropriate. The merit of the explanation will be considered if one is given.

a Answer *true* or *false* and give explanation if you wish to do so. Assume that all of the income in question relates to 1952 only.

(1) Mr. Grey is the sole beneficiary of a trust whose entire corpus consists of municipal bonds. The trust was created under the will of Grey's father which stated that the income therefrom is distributable currently. The income is taxable to Mr. Grey when received.

(2) Mr. Roe is an amateur novelist. He submitted one of his works to a contest and was awarded first prize, consisting of $5,000 in cash. The proceeds are tax-free.

(3) In 1950, Mr. Brown was injured in an automobile accident and commenced a negligence action against the owner of the other vehicle. No medical deduction was claimed for expenses incurred in this connection. In 1952, Mr. Brown received $50,000 in damages pursuant to a judgment rendered in his favor. The full amount is taxable.

(4) Mr. Doe is the sole stockholder of the X Corporation. The corporation was formed in 1947 and the basis for Doe's stock is $250,000. The corporation's tax returns filed for its first five years (all of which were accepted as filed by the Treasury) showed net operating losses of $20,000 for each year. This was properly shown on the balance sheet at December 31, 1951, as a deficit of $100,000. For 1952 taxable income of $50,000 will be reported, but no tax will be payable, due to the net operating loss deduction. In December 1952 a dividend of $50,000 was paid to Mr. Doe after having obtained an opinion from counsel that state law was not violated thereby. The full amount of this distribution is a return of capital and therefore tax-free.

(5) Mr. White's mother made a gift to him on his birthday (June 15, 1952) consisting of 100 shares of General Motors stock, at which time the quoted market price was $60 per share. Mr. White should report $6,000 as taxable income in his 1952 return.

(6) Mr. Smith owns a ranch for which he purchased ten head of cattle on October 1, 1951, at a cost of $500, to be used for breeding purposes. On July 1, 1952, all of these cattle were sold for $1,400. Depreciation from date of acquisition to July 1, 1952, was $100. The profit of $1,000 is ordinary income.

(7) Mr. Smith acquired his ranch in 1940 by paying $50,000 in cash and obtained a mortgage loan of $100,000. From date of acquisition to 1952 the mortgage has been reduced by amortization payments of $28,000, leaving a balance of $72,000. During 1952, Smith repurchased his mortgage note (which was in negotiable form) for $50,000. Smith realized no taxable income on this transaction.

(8) The X Corporation, as described in question *a* (4) above, has had no taxable income during the period from 1947 (inception) to 1951. In its first year it paid and deducted a certain franchise tax amounting to $2,000. During 1952, after several administrative hearings, a refund was obtained. The full $2,000 is tax-free in 1952.

(9) The A Corporation owns a parcel of vacant land that was occupied by a tenant in 1952. The lease agreement provided that in lieu of rent the tenant shall erect a certain structure on the land, which would revert to the A Corporation upon expiration of the term of the lease (one year). The tenant fulfilled its part of the agreement and vacated on December 31, 1952, leaving a small building having a fair market value of $2,500. This amount should be reported as rent income in the A Corporation's 1952 return.

(10) The A Corporation also owns some timber land. By making a proper election, it may report on its return long-term capital gains by cutting timber which need not be sold before the end of 1952.

(11) During 1952, B Corporation traded in a tractor having an adjusted basis of $2,000, paid cash of $2,000 and received a new tractor in exchange, having a fair market value of $5,000. The $1,000 profit on the exchange should be reported as a capital gain.

(12) Mr. Brown owned in the State of Florida an orange grove that he operated

profitably for several years and sold during 1952. That portion of the profit that he realized from the sale relating to the unharvested fruit is ordinary income.

b Answer *true* or *false* and give explanation if you wish to do so. Assume that the following deductions relate to 1952 only.

(1) The ABC Corporation has an inventory of widgets that has always been priced at LIFO. At December 31, 1952, the LIFO inventory is $125,000, but market is $100,000. The LIFO inventory may be written down to market for Federal tax purposes and the $25,000 difference may be charged to cost of sales.

(2) The C Corporation had accounts receivable at December 31, 1952, aggregating $200,000, in respect of which a cash discount of 2% is allowed, if paid not later than January 10, 1953. A reserve for discount of $4,000 was recorded in the accounts. The offsetting charge to income is deductible.

(3) The D Corporation sold for $50,000 a plant building which was acquired in 1940. The adjusted basis of D Corporation for such building was $100,000. The $50,000 loss is a capital loss. (Assume that there were no other gains or losses on sale of depreciable property or land used in trade or business.)

(4) The E Corporation acquired a certain machine on January 2, 1952, that cost $50,000 and is used in connection with certain government contracts. An application for a certificate of necessity was filed and certification was received during the year in respect of 65% of the emergency facility. If a proper election is made, amortization of $6,500 may be claimed on the 1952 return.

(5) The F Corporation adopted a trusteed pension plan in 1952 that covered 80% of all personnel. Proper approval was obtained from the Treasury. The actuaries informed the company that a payment of $50,000 to the trustee was necessary to fund the cost under the plan based upon past service, in addition to current service cost of $4,000. The company paid $5,000 on December 31, 1952, and $49,000 on March 5, 1953. The full amount of $54,000 is deductible in 1952.

(6) Mr. Green resides in a suburb of Chicago and has recently been appointed chief counsel to a government agency in Washington, D. C. Mr. Green's duties as chief counsel require his presence in Washington during ten months of 1952. He can deduct the rent paid for his Washington apartment, plus other living expenses, inasmuch as Illinois is his permanent residence.

(7) Mr. Jones paid a fee of $1,000 in 1952 to an estate-planning expert for drawing a will and advising him with respect to Federal estate taxes. This may be deducted on his 1952 return.

(8) Mr. White borrowed $100,000 from a bank to purchase municipal bonds having a redemption value of $90,000, which were then pledged as security for the loan. The interest paid on the loan for 1952 may be deducted.

(9) Mr. Big is the owner of a certain oil lease. The gross income for 1952 from the lease was $100,000 and expenses other than depletion aggregated $70,000. Percentage depletion of $27,500 is allowable since it is greater than cost depletion of $20,000.

(10) Mr. Blue received dividends from certain Canadian stocks upon which 15% Canadian income tax was withheld at source inasmuch as Blue is an American citizen. The Canadian income tax, like Federal income tax, is not deductible.

(11) Mr. Smart paid traffic violation fines totaling $100 in 1952. The full amount is deductible in computing net income.

(12) The garage on Mr. Doe's Illinois residence was damaged in 1952 during a hailstorm. The original cost was $3,000. Its fair market value immediately prior to the storm was $5,000 and was $1,000 thereafter. A casualty loss of $4,000 may be claimed by Mr. Doe.

2 [8]

Pitts-Marvel Sales Corporation sells goods and accounts for such sales on the installment basis. At the end of each year it takes up gross profit on these sales in the year(s)

of collection rather than in the year of sale and considers each collection to be composed of cost and gross profit elements.

The balances of the control accounts for Installment contracts receivable at the beginning and end of 1952 were:

	January 1, 1952	December 31, 1952
Installment contracts receivable—1950	$ 24,020	—
Installment contracts receivable—1951	344,460	$ 67,440
Installment contracts receivable—1952	—	410,090

As collections are made, the company debits Cash and credits Installment contracts receivable. During 1952, upon default in payment by customers, the company repossessed merchandise having an estimated resale value of $1,700. The sales had been made in 1951 for $5,400, and $3,200 had been collected prior to default. The company recorded the default and repossession by a debit to Inventory of repossessed merchandise and a credit to Installment contracts receivable—1951 for the uncollected balance.

The company's sales and cost of sales for the three years involved are summarized below:

	1950	1951	1952
Net sales	$380,000	$432,000	$602,000
Cost of sales	247,000	285,120	379,260

Required:

a Prepare journal entries to record at December 31, 1952, the recognition of profits and any other adjustments arising from the above data. Give complete explanations in support of your entries.

b Give one acceptable alternate method of handling the repossession and discuss the relative merits of it as compared to the method you used in *a*.

3 [30]

You are engaged in your second annual audit of Richardson's Chemix, Inc., as of December 31, 1952. The company manufactures a single product, Chemix.

One pound of basic raw material is required for the production of one pound of finished product. All production is completed at the close of each day. Other materials, in relatively minor quantities, are added at approximately the same rate as are direct labor and manufacturing overhead. For this reason, Miscellaneous materials used is included as part of overhead in Processing costs.

For the purpose of monthly adjustment of the books and interim statements, processing unit cost is computed monthly at a predetermined percentage of average unit cost of basic materials. At the end of the year, finished product inventory valuation is adjusted to the *average* cost of basic material issued from stores plus *actual* processing costs. Inventories are carried at cost in the statements.

In prior years the company shipped its product in non-returnable cardboard containers, but as of January 1, 1952, the management converted to new returnable metal containers which cost $6 each. These new containers average six deliveries each before being scrapped. To encourage return of the new containers, customers are billed $9 per container, credit for which amount is granted upon return of the container in good condition. Containers remain the property of the client, and billings for them are considered to be in the nature of customers' deposits.

Control accounts are maintained for the following profit and loss items: Processing costs, Selling and distribution expense, General and administrative expense, and Other additions and deductions.

Required: You are to prepare working papers that show in detail "Balance per books 12/31/52," "Audit Adjustments," "Profit and Loss for Year," and "Balance Sheet 12/31/52." (Separate work sheets may be prepared for Balance-Sheet accounts and for Profit and Loss accounts.) Key all audit adjustments and prepare formal journal entries that will provide a clear explanation for each of your adjustments. Also prepare schedules supporting your entries for Returnable containers, Finished product inventory and Federal income tax payable.

Note: A summary of the ledger accounts showing the opening balance, transactions and book adjustments, and closing balance for each account follows. (There are no footing, extension, or posting errors in the following work sheets.)

RICHARDSON'S CHEMIX, INC.

WORK SHEET — DECEMBER 31, 1952

	Per Books 12/31/51		Transactions and Adjustments Per Books				Per Books 12/31/52	
	Debit	Credit		Debit		Credit	Debit	Credit
Cash	$103,500		(5)	$1,775,560	(7)	$1,760,490		
			(12)	4,850	(11)	9,460	$ 113,960	
Accounts receivable—trade	70,000		(1)	1,711,000	(3)	96,000		
					(5)	1,577,800		
					(6)	2,400	104,800	
Estimated uncollectible accounts		$ 2,000	(6)	2,100	(10)	3,500		$ 3,400
Finished product inventory	92,000		(4)	15,100	(2)	1,027,000		
			(9)	1,071,000				
			(19)	900			152,000	
Raw material inventory	38,500		(8)	741,500	(9)	714,000	66,000	
Miscellaneous materials inventory	8,000		(18)	11,025			19,025	
Returnable containers			(4)	48,000	(2)	54,000		
			(8)	24,000	(17)	1,440	16,560	
Prepaid insurance	2,300		(8)	14,300	(14)	14,200	2,400	
Cash value of life insurance	3,500		(14)	400			3,900	
NAR Distributors, Inc. stock			(8)	23,000				
			(21)	2,000			25,000	
Land	10,000						10,000	
Building	100,000		(8)	120,000			220,000	
Accumulated depreciation—building		25,000			(15)	3,300		28,300
Machinery and equipment	65,000		(8)	12,500			77,500	
Accumulated depreciation — machinery and equipment		35,000			(15)	8,050		43,050
Vouchers payable		31,000	(7)	1,760,490	(8)	1,768,965		
					(20)	10,100		49,575
Withheld and accrued taxes		4,940	(8)	88,320	(8)	73,400		
					(16)	27,000		17,020
Federal income tax payable		23,890	(8)	23,920	(22)	48,400		48,370
Mortgage bonds payable					(5)	197,760		197,760
Capital stock (stated value $50)		50,000			(13)	25,000		75,000
Paid-in surplus		46,920						46,920
Retained earnings		274,050	(13)	25,000	(21)	2,000		
					(12)	100		251,150
Treasury stock			(11)	9,460	(12)	4,750	4,710	
Sales			(3)	96,000	(1)	1,711,000		1,615,000
Cost of sales			(2)	1,081,000	(4)	63,100		
			(17)	1,440	(18)	11,025		
			(20)	10,100	(19)	900	1,017,515	
Processing costs applied					(9)	357,000		357,000
Processing costs			(8)	310,825				
			(14)	9,050				
			(15)	10,000			329,875	
Selling and distribution expense			(8)	302,000				
			(14)	2,975				
			(15)	550			305,525	
General and administrative expense			(6)	300				
			(8)	177,000				
			(14)	1,775				
			(15)	800				
			(16)	27,000				
			(10)	3,500			210,375	
Other additions and deductions			(8)	5,000			5,000	
Federal income tax			(22)	48,400			48,400	
	$492,800	$492,800		$9,572,140		$9,572,140	$2,732,545	$2,732,545

The following entries, as shown in the work sheet, summarize the transactions for the year:

(1) Accounts receivable—trade		$1,711,000	
Sales			$1,711,000
Sales of Chemix	$1,630,000		
Returnable containers—9,000 @ $9.00	81,000		
	$1,711,000		
(2) Cost of sales		1,081,000	
Finished product inventory			1,027,000
Returnable containers			54,000
To cost sales made during the year.			
(3) Sales		96,000	
Accounts receivable—trade			96,000
Sales returns: CHEMIX	$24,000		
Containers returned—8,000 @ $9	72,000		
	$96,000		
(4) Finished product inventory		15,100	
Returnable containers		48,000	
Cost of sales			63,100
To restore returns to inventory.			
(5) Cash		1,775,560	
Accounts receivable—trade			1,577,800
Mortgage bonds payable			197,760
Receipts from customers on account and the net proceeds of a 20-year, 5% bond issue, dated 7/1/52, interest payable each January 1 and July 1. Entire issue was sold on 10/1/52 at 99, plus accrued interest. Costs of issue of $2,740 were paid.			
(6) Estimated uncollectible accounts		2,100	
General and administrative expense		300	
Accounts receivable—trade			2,400
To write off accounts proved uncollectible: 1951 sales, $2,100; 1952 sales, $300.			
(7) Vouchers payable		1,760,490	
Cash			1,760,490
To record payments of vouchers.			
(8) Raw material inventory		741,500	
Returnable containers		24,000	
Prepaid insurance		14,300	
NAR Distributors, Inc. stock (1,000 shares)		23,000	
Processing costs (salaries and wages, miscellaneous materials, etc.)		310,825	
Selling and distribution expense (salaries, etc.)		302,000	
General and administrative expense (salaries, etc.)		177,000	
Other additions and deductions (interest)		5,000	
Withheld and accrued taxes		88,320	
Federal income tax payable		23,920	
Building		120,000	
Machinery and equipment		12,500	
Withheld and accrued taxes			73,400
Vouchers payable			1,768,965

Per voucher register. The vouchers charged to Building were for construction of a factory extension completed in November. Those charged to Machinery and Equipment were for machinery installed in the factory extension. The contract price for the machinery was $52,500, payable $10,000 down and the balance in 17 monthly installments of $2,500 each payable the 10th of each month.

(9) Finished product inventory	$1,071,000	
Raw materials inventory		$ 714,000
Processing costs applied		357,000

For cost of completed production.

(10) General and administrative expense	3,500	
Estimated uncollectible accounts		3,500

To record provision for bad debts. The treasurer and credit manager reviewed the accounts and decided that $3,500 were doubtful. You later reviewed the accounts with them and agreed with their evaluation.

(11) Treasury stock	9,460	
Cash		9,460

Purchase of 100 shares:
Sept. 16—40 @ 94
Nov. 2—60 @ 95

(12) Cash	4,850	
Treasury stock		4,750
Retained earnings		100

Sale of 50 shares purchased November 2.

(13) Retained earnings	25,000	
Capital stock		25,000

Net entry for declaration and issue of 500 shares as a 50% stock dividend in July.

(14) Cash value of life insurance	400	
Processing costs	9,050	
Selling and distribution expense	2,975	
General and administrative expense	1,775	
Prepaid insurance		14,200

To amortize insurance per register and to set up portion of $500 premium for increase in cash surrender value of life policy.

(15) Processing costs	10,000	
Selling and distribution expense	550	
General and administrative expense	800	
Accumulated depreciation—building		3,300
Accumulated depreciation—machinery and equipment		8,050

To record depreciation charges, per schedule:

Asset	Annual Rate	Cost	Processing	Selling	Office & General
Building	2½%	$100,000	$ 2,250	$150	$100
Bldg. Ext.	4%	120,000	800		
M & E	12%	65,000	6,700	400	700
M & E	12%	12,500	250		
			$10,000	$550	$800

		Debit	Credit
(16) General and administrative expense		$ 27,000	
Withheld and accrued taxes			$ 27,000
For accrual of employer's share of payroll taxes at 4½% of total payrolls:			
Factory	$250,000		
Selling and distribution	250,000		
General and administrative	100,000		
(17) Cost of sales		1,440	
Returnable containers			1,440
Net inventory adjustment:			
Of the 1,000 containers not returned, salesmen reported that customers had only 800 on hand at December 31, of which 300 had been used but once and 500 of which were not returnable as they were being used as mixing pots. The inventory record indicates 3,000 on hand at the plant on December 31, but a physical count showed only 2,940 (940 new; 2,000, 50% used).			
Containers with customers	300		
Less—plant adjustment	60		
Net adjustment at $6 each	240		
(18) Miscellaneous material inventory		11,025	
Cost of sales			11,025
To adjust to physical inventory at 12/31/52.			
(19) Finished product inventory		900	
Cost of sales			900
To adjust value of 100,000 lbs. in inventory at December 31, to a unit cost of $1.52 per lb.	$152,000		
Balance per ledger	151,100		
Adjustment	$ 900		
Material issue cost per perpetual inventory records	$1.02		
Actual processing cost $330,000 divided by 660,000 lbs. sold in 1952	.50		
	$1.52		

(20) Cost of sales		$ 10,100	
Vouchers payable			$ 10,100
To record liability for 10,000 lbs. of raw material in transit at December 31 @ $1.01 per lb.			
(21) NAR Distributors, Inc. stock		2,000	
Retained earnings			2,000
To adjust to quoted bid prices at 12/31/52.			
(22) Federal income tax		48,400	
Federal income tax payable			48,400
To record estimated tax for 1952:			
Net income per books before F I tax	$103,710		

Combined normal tax and surtax:

52% of $103,710	$53,929.20
Less	5,500.00
Computed tax	$48,429.20

Additional data:

a The accrued payroll tax liability recorded by the client included tax on the following exempt payroll: factory $30,000; selling $70,000; general $40,000.

b All tax rates used by client may be considered as correct. State franchise, state income tax and Federal excess profits taxes are to be ignored.

c A summary of transactions from the perpetual inventory records for raw materials follows:

	Pounds	Amount	Average Unit Price
Balance 1/1/52	35,000	$ 38,500	$1.10
Purchases	731,000	741,500	1.014
Total available	766,000	$780,000	$1.018
Issued for processing	700,000	714,000	1.02
Balance 12/31/52	66,000	$ 66,000	$1.00

d Of the 12/31/52 balance of accounts receivable, $9,000 was for containers. You have discussed with the client the accounting treatment accorded returnable containers and have reached agreement with the client that, since the containers remain the property of the company, billings for them should not be taken up in Sales. In this discussion you have suggested alternate ways of treating container losses and amortization in the income statement. For reasons which you accept as valid, the client has now decided to charge container losses and amortization to Selling and distribution expense and to apply as a reduction of this expense any gains on containers not returned.

e Your review of the minutes book reveals that the directors intended to freeze $50,000 of retained earnings by means of the 50% stock dividend recorded.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Proposed New Internal Revenue Code

The House Ways and Means Committee is presently engaged in rewriting the Internal Revenue Code, a codification of the tax laws which has been in effect since February 10, 1939. Since that date there have, of course, been numerous amendments to the Code. The contemplated revision is a major operation recommended by the President as a thorough revision of the whole tax system, and will take the form of a new Internal Revenue Code. It is bound to have a palpable impact on the New York State Income Tax law, since our Legislature and the State Tax Commission will doubtless also consider making some of the changes.

The Ways and Means Committee has already released quite a number of proposed changes that have been adopted by the Committee on a tentative basis. Most of the proposals will probably become law, subject to possible changes after the Senate considers the new Code. Because of our interest in the new developments, we shall consider a few of the proposed changes, particularly in the light of the New York law and the possibility of changes to conform with the Federal law.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is a past Vice-President of the Society and is now serving on the Society's Committees on Awards and Publications. He is a past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Taxation of Dividends

For years, taxpayers have agitated for the elimination in whole or in part of the tax on dividend income. To the taxpayer there was a serious inequity in subjecting such income to double taxation, first as part of corporate income and again as income to the stockholder. A new and unique proposal looking to the elimination of the double taxation of corporate dividends has been approved by the Ways and Means Committee. It is stated to be only a first step and takes the form in part of an exclusion from income, and in part of a credit against the tax. $50 of dividend income is excluded for the taxable year ending after July 31, 1954, and before August 1, 1955, and $100 of dividend income is excluded in subsequent taxable years. In addition to this, a credit against the tax of 5% is provided for dividends in excess of the exclusion received after July 31, 1954, and before August 1, 1955; with the credit increased to 10% for dividend income received thereafter.

Under New York law, a business corporation is not taxed on dividends received from subsidiary companies and it is taxed only on 50% of dividends received from other corporations. Under Federal law, a corpora-

tion is not taxed on 85% of dividends received. Dividends received by stockholders are of course part of gross income fully subject to income tax. Presumably, the State will also seek to provide some method of ameliorating the impact of double taxation of dividends.

Annuities and Life Insurance Contracts

Under the present law, federal and state, 3% of the cost of an annuity is includible as gross income. Payments in excess of three percent are excluded until the total amounts excluded equal the cost of the annuity. Thereafter, all annuity payments are taxable in full. Taxpayers have considered this treatment inequitable, first because the arbitrary rate of 3% is unrealistic, and, second, because the taxpayer may not recover his cost during his lifetime.

Under the new proposal the annual exclusion will equal the cost of the annuity to the taxpayer divided by his life expectancy at the time the annuity payments start. This exclusion will remain fixed even though the taxpayer lives beyond his life expectancy.

A different provision is made for employee annuities, if the amounts payable to the employee in the first three years equal or exceed the employee's cost. In such cases, the entire annuity received will be excluded until the employee has recovered his cost, and after that the annuity payment will be taxable in full.

In the case of joint and survivor annuities the annual exclusion is to be spread over the combined life expectancy of the annuitants.

The new proposal will become effective as of January 1, 1954. Life expectancy will be determined as of that date. The cost to be recovered tax-free will be reduced by any amounts already received tax-free under the present 3% rule. The new proposal will also be applied to paid-up life insurance contracts, under which a policyholder elects, within 60 days after he has the right to receive a lump sum, to receive installment payments instead. The policyholder will not be taxed as if he had received the face amount of the policy, as he is under the present law. Instead the Committee has approved a provision that the tax shall be no greater than if one-third of the taxable portion of the lump sum had been received in the current year and one-third in each of the prior two years. This manner of treating proceeds of an annuity, endowment or life insurance contract received in one lump sum is like the treatment of compensation received in one year covering services performed over a period of 36 months.

The new provisions could very well be adopted by the State and possibly will be the basis for future changes in the State law.

Employee Death Benefits

Under present law, death benefits paid to a deceased employee's beneficiaries to the extent of $5,000 from any one employer are excluded from gross income. The Ways and Means Committee has adopted a provision that this exclusion be limited to $5,000 with respect to any one employee. Under present law an employee who had more than one employer could receive more than one $5,000 exclusion.

Furthermore, this exclusion now applies only where the employer has contracted to pay the benefit. The new provision eliminates the requirement of a prior contract. As a matter of fact, the exclusion is not available if the employee has a non-forfeitable right to the benefits before death. If annuities or pensions are payable to a deceased employee's beneficiaries, $5,000 may be added to the employee's consideration for the annuity. This $5,000 will be recoverable tax-free.

The 1953 New York Legislature introduced a provision similar to the

(Continued on page 285)

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

SEC Dismisses Proceeding Against Accountants

Like many other government commissions, the SEC has Rules of Practice. Rule II(e) provides that the Commission may disqualify and deny, temporarily or permanently, the privilege of appearing or practicing before it to any person who is found by the Commission to be lacking in character or integrity or to have engaged in improper professional conduct. Proceedings under this rule are usually private. Ordinarily the first public indication of proceedings under the rule is when the Commission makes known its findings.

The SEC on February 19, 1954, published its findings in a proceeding under Rule II(e) to determine whether a certified public accountant should be denied the privilege of practicing before the Commission. The information published by the Commission was in the form of Release No. 77 of its Accounting Series. The release is very brief and, in our view, raises a number of questions.

The Commission reported that the accountant involved in this case had certified financial statements of a broker-dealer filed under the Securities Exchange Act of 1934. Neither the broker-dealer nor the accountant is identified by name.

The broker-dealer was a partnership engaged principally in the commodities brokerage business and had one branch office which was managed by a junior partner. After consulting with the senior partners of the broker-dealer firm, the accountant decided that it would not be necessary to visit and audit the branch office in order properly to audit the firm's financial statements because of "their" belief that all of the assets and the liabilities of the branch office were reflected in the books of the principal office and were susceptible to verification at the latter office. (We assume that this was the belief of the senior partners, and that the accountant did not disagree.)

Because the identities of the broker-dealer and the accountant have not been revealed, we have not seen the certificate of the accountant. The SEC, however, in its release says that "the accountant qualified the opinion expressed in the certificate, that the financial statements fairly presented the financial position of the broker-dealer, with the statement that its examination of the branch office was 'limited to a verification of recorded assets and liabilities' ". (This appears to have been a qualification as to scope, which may, however, have been referred to in the opinion paragraph of the accountant's report.)

The senior partners in the broker-dealer firm discovered that the junior partner operating the branch office had reported fictitious purchases, sales and profits in commodities to the principal office, thereby resulting in an overstatement of the broker-dealer's assets and the falsity of its financial statements.

The "qualification" in the accountant's certificate as to the scope of his examination appeared in the financial

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reports filed with both the New York Stock Exchange and the SEC for the years 1947 through 1951 and, according to the SEC, "neither the Exchange nor the Commission's staff made any comment thereon".

The accountants sent confirmation forms to customers having open balances according to the broker-dealer's books and, although a high percentage of such forms was returned, none was received challenging the accuracy of the stated balances. The local bank used by the branch office confirmed certain liabilities and an account of the broker-dealer firm but, said the SEC, "such confirmation did not include information as to an account of the junior partner in that bank which was carried in his own name but was used in connection with the firm's transactions."

Apparently the hearings did not establish whether examination of the branch office would necessarily have resulted in discovery of the fictitious transactions. It appeared to the SEC, however, that an investigation of the junior partner's bank account would have led to such discovery. The local bank denied that it was under a duty to report information in its possession concerning the junior partner's bank account to the accountant. The Commission said it recognized that the accountant did not receive such information and that fact contributed in considerable measure to the failure to discover the existence of the fictitious transactions. (Is the SEC suggesting that the accountant should have inquired into the personal accounts of partners? Does the SEC believe that the bank is under a duty to disclose information not specifically requested?)

The Commission was of the opinion that while more thorough auditing procedures might have resulted in the discovery of the fictitious transactions, the record in this case did not disclose a lack of the requisite qualifications, or a lack of integrity, or improper professional conduct, and accordingly the proceedings against the accountant were dismissed. The Commission's release would have been more helpful to those who practice before the SEC if it had explicitly stated what additional auditing procedures the SEC believed should have been followed by the accountant.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Improving Retainer Fees

Annual retainers are a common fee arrangement for accountants, particularly where interim audits are performed. However, retainers generally involve an element of speculation which can be at one time disadvantageous to the client and at another unfair to the accountant. The accountant tries to bring the amount to a level that will provide a cushion for contingencies, and may thereby make his retainer excessive. But the client, to the contrary, attempts to lower the fee to reduce his costs, sometimes creating an inequitable situation for the accountant.

Even if a retainer is based on prior years' experience, there is no assurance that an inequity to the accountant cannot develop in a future year. It is professionally offensive that personal services of an unlimited amount should be offered for a limited fee. Moreover, businessmen do not so sell their wares. Nevertheless, the retainer arrangement is one that is probably here to stay and must be lived with. Some ways and means of reducing the adverse effects are here discussed.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

What should be included in the retainer?

By limiting the retainer services only to those that properly lend themselves to such an arrangement, other types of services would therefore be subject to billing. The accountant should be careful to point out that a retainer scope, in principle, encompasses only such services as are reasonably predictable as to effort involved and are regular in occurrence

Based on the above definition of retainer services, the following activities could, for example, be omitted and be subject to extra charges:

1. Tax examinations—because the effort is not predictable.
2. Conferences with clients on non-routine matters and such as are not connected with the regular operations of the business—because such conferences are unpredictable as to occurrence and time requirement, and their importance and value should be given consideration. What is "routine" is a matter to be worked out between the accountant and the client and, admittedly, is not an easy matter. Yet we cannot escape it unless we just yield by default.
3. Special services, such as investigations, system work, cost work, etc.—because such services are unpredictable as to occurrence, time, and effort involved and because such services are deserving of extra consideration.

It does not follow that an accountant should, in every instance, make a charge for services outside of the retainer scope. He should have that right, and exercise it according to his judgment and in the light of all surrounding circumstances.

Reducing adverse effects

1. Minimum - Maximum retainer plan:

In place of one rigid ceiling, two may be included in the arrangement. This plan calls for a minimum fee of X dollars with provision for increase up to Y dollars if warranted by increased time requirements due to conditions not within the accountant's control. Thus the inflexibility is reduced and the client can still predict the approximate service cost for the ensuing year.

2. Renegotiation plan:

The idea that a client should be able or willing to capitalize on an accountant's inability to guess right for a year in advance is offensive and unconscionable. It is inconsistent with the importance and confidential nature of the association. For that reason it should be understood in advance that the fee is subject to renegotiation, upwards or downwards, in the event of substantial difference in time and effort involved in relation to what was contemplated in the retainer estimate. This may be tantamount to a per diem rate arrangement, which is not an undesirable one.

3. Time limitation plan:

Time limitations may be a means of arresting an adverse trend before it becomes too damaging to the accountant. This may be particularly useful with respect to the time of principals —partners or individual practitioners, and staff experts. The arrangement might provide for revision of the retainer when the maximum time limit is reached. This plan is helpful in avoiding needless diversions of time.

4. Specify the retainer services:

If the retainer scope is written out, services in excess of those specified automatically become billable. Thus, if the monthly audits call for 12 senior days a year and 24 junior days, a definite basis exists. A definition of what is "routine" might even be written out, as a guide for future determinations.

Personality and other aspects

Human relations do not conform to rigid rules. Fee negotiations will continue to be problems indefinitely. The generosity of a fee depends, on the one hand, on the nature and capacity of the client, and, on the other hand, on the personal traits of the accountant, his own status, experience, competence, sales ability, and his professional concepts. Sound and adequate preparation for a fee discussion will inevitably lead to a better arrangement.

Expressions of views on retainer arrangements, and experiences, are solicited from readers. Communications of general interest will be published, with or without acknowledgment of the source as specified by the writer.

Management Services

The role of the public accountant as an adjunct of business management has been a pet project of the writer of this column for many years. Increasing recognition has been given to this subject over the years. An important, forward-looking step is being taken by the American Institute of Accountants by the organization of a committee to study the subject in all of its ramifications. The Institute's news letter (March, 1954) describes its project as follows:

> "A new committee on management services by CPAs has been appointed by AIA President Arthur B. Foye. Headed by Harold A. Mock of Boston, it will hold its first meeting in Washington, D. C., March 19 and 20.
>
> Duties of the nine-man committee will be to explore the extent of management services rendered by CPAs; outline the contents of a publication to guide practitioners in this area; and recommend a procedure for preparation and production of the publication.

Questions to be considered will include what advisory services CPAs are equipped to handle, how accounting relates to management decision, how a CPA should prepare himself for management services, what are reasonable standards of performance in this field, and what is a reasonable compensation for advisory service."

This committee's proposals could have a profound effect on the scope of the certified public accountant's services, and its conclusions should be eagerly awaited and carefully considered by all practitioners.

Extensions of Time for Filing Corporate Tax Returns

The Commissioner of Internal Revenue has promulgated a most generous ruling regarding extensions for filing income tax returns. Merely by filing Form 7004, signed either by the taxpaper or his accountant, an extension for 90 days is automatically granted.

Accountants should recognize that they have been granted a privilege—that its preservation depends on their actions in avoiding abuses.

New York State Tax Forum

(Continued from page 280)

present federal rule. This was effective beginning on or after January 1, 1952. The new proposals will probably be followed by the State.

Deduction for Depreciation

It seems to be the desire of taxpayers to take a maximum deduction for depreciation as rapidly as possible. The basis for depreciation generally is cost, and the period over which cost can be charged off is the life of the asset. The Ways and Méans Committee has introduced a method of accelerating the depreciation deduction over the life of the asset. Generally, taxpayers use a straight-line method of computing depreciation. The Committee suggests that the declining-balance method be used, and provides further that the maximum deduction under this method may be twice the amount available under the straight-line method. Under this method about ⅔ of the cost of an asset will be depreciated during the first half of its life. The declining balance method will apply only to property acquired or constructed after December 31, 1953.

The Committee also proposed that taxpayers may enter into written agreements with the Internal Revenue Service with respect to the useful life and rate of depreciation for assets. Such agreements may be modified by the presentation of facts and circumstances not taken into account at the time the agreement was made and will be effective prospectively.

Another change provides that unless the life of an asset as determined by the Internal Revenue Service differs by more than 10% from the life used by the taxpayer, the taxpayer's rate of depreciation is to be accepted.

Article 175 of the New York State Income Tax Regulations permits the use of a declining-balance method for determining amounts to be deducted annually for depreciation. It does not, however, presently provide for doubling the rate available under a straight-line method.

Payroll Tax Notes

Conducted by Samuel S. Ress

Unemployment Insurance: Rights to Benefits—When to Contest a Claim

Benefits are payable to claimants who meet the requirements set forth in the law. The filing of a valid original claim by an unemployed individual is a primary requisite. It is of importance to know the conditions that result in the suspension, disqualification, or reduction of benefits. Employers' experience rates may be adversely affected by unwarranted benefit payments. An employer's request to deny benefits must be made promptly. The purpose of the conditions precedent to the payment of benefits is to limit payments only to bona fide applicants. The conditions that must be met by a claimant, and of interest to the employer whose account will be charged are:

1. *The claimant must be able and willing to work after having suffered a real loss of employment.*

2. *The claimant's right to receive benefits must not be suspended because of loss of employment due to an industrial controversy or misconduct.* Each suspension runs for 7 weeks beginning with the day after the claimant lost his employment. No registration for benefits is necessary when benefits are suspended for the foregoing reasons. However should the suspended claimant register for benefits during the suspension period, the employer should notify the local unemployment insurance office that the loss of employment was due to misconduct or industrial controversy.

As to what is or is not an industrial controversy or misconduct that may result in suspension of benefits has been the subject of thousands of cases.

3. *An individual who applies for benefits and then refuses suitable employment is subject to an indefinite disqualification period.* This period does not expire until after he has indicated his reentry into the labor market by obtaining another job or demonstrating to the Division of Employment that he is ready, able and willing to work. Disqualified claimants must register and serve the required disqualification period following their registration for benefits. A claimant who quit his job voluntarily without good cause is required to register for benefits so that the six-weeks disqualification period can run, following which he is permitted to file a valid original claim.

4. *Members of another group of claimants may have their Unemployment Insurance Benefit claims reduced as punishment for having wilfully misrepresented to the Unemployment Insurance Division that they were entitled to Unemployment Insurance benefits.*

5. *A claimant must be fully insured.* To be considered as such, he must have worked in at least twenty weeks of employment in which his average weekly remuneration was at least $15.00 per week.

Samuel S. Ress has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is Vice Chairman of the Society's Committee on Labor and Management and a member of its Committee on State Taxation.

Partial Unemployment Benefits

The law also provides for payment of partial Unemployment Insurance benefits under certain conditions. When an individual files a claim for Unemployment Insurance benefits, the Industrial Commissioner will correspond with the principal employer of the claimant. The principal employer is the claimant's last employer by whom he was employed for at least 20 weeks. However, if a claimant did not have 20 weeks employment with any one employer during the preceding 52 weeks, then the Commissioner must send requests for wage information to all the employers by whom the claimant had been employed during the 52-week period immediately prior to his application for benefits. All those employers must reply on pain of receiving $10.00 Request Report Penalties for non-compliance.

Industrial Misconduct in Unemployment Insurance

A recent court decision sets forth the conditions under which a suspension of benefits because of "industrial misconduct" applies.

The following are *not* considered misconduct for Unemployment Insurance purposes:

1. Mere inefficiency.
2. Unsatisfactory conduct.
3. Failure in good performance as a result of inability or incapability.
4. Inadvertency or ordinary negligence in isolated instances.
5. Good-faith errors in judgment or discretion.

The following actions on the part of an employee constitutes industrial misconduct:

1. Deliberate violations or disregard of standards of behavior which the employer has the right to expect of his employee.
2. Carelessness or negligence of such degree or recurrence as to manifest equal culpability, wrongful intent or evil design.
3. Carelessness or negligence of such degree or recurrence as to show an intentional and substantial disregard of the employers interests.
4. Carelessness or negligence of such degree or recurrence as to show in intentional and substantial disregard of the employee's duties and obligations to his employer.

There may be other additional conditions which reflect misconduct besides those indicated above.

In contesting claims for benefits, employers or their representatives should see whether or not the claim can be contested on the basis of any of the preceding principles. If the alleged misconduct of the employee does not fit into the categories described above, then the employer may jeopardize the ten or twenty-five dollar deposit that he must post should he desire to oppose a payment of benefits to a former employee who was laid off because of industrial misconduct or for any of the other reasons outlined above.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

Six years ago you published in your January (1948) issue an article in which I suggested that corporate reports might be made more valuable (without any change in the concept of income reflected in them) by distinguishing between that part of income which represented gain measured in units of the same purchasing power, and the remainder which was brought into account by the combination of accounting conventions and price inflation. While this sub-division could not be made precisely, it could be made within the limits of accuracy normally attained in accounting determinations, e.g. in depreciation accounting.

This January your Journal contains an article warning, in the name of tradition and objectivity against any profanation of the mysteries of the accounting art. The writer urges that accounting should continue to be a process of matching specified costs against bargain-determined sales prices—which, in fact, it ceased to be long ago when ordinary business came to be conducted by corporations having a perpetual life and making annual reports. When this happened, venture accounting, with some exceptions, notably voyage accounting, gave way to period-income accounting.

No doubt business income is still an excess of revenues over cost, but as I said in an amplification of my remarks at the Sixth International Congress, which was published in *The Accountant* of October 18, 1952:

> "What accounting is concerned with in income determination is not a group of specific costs readily identifiable with revenue, but a pool of costs. In this pool there may be actual costs and standard (or ought-to) costs; costs of tangibles and costs of intangibles; costs incurred in money and costs conventionally attributed to property acquired by the issue of securities; production costs and period costs; original costs and costs of replacement; direct costs and indirect costs; fixed costs and variable costs; past costs and expected future costs; costs that are in excess of market and costs that are less than market, etc. and many hybrids."

If accounting were in fact determined as the writer in question suggests, accounting would be less, not more, subjective than it is today. For the power of management to influence income determination by subjectively deciding whether transactions should or should not be entered into, and if so in what precise form would be increased. The cost or market rule (which has a longer history than the "traditions" of which the article speaks) puts a major limitation on such possibilities.

It is gratifying to see that the Society of Accountants and Auditors in England and the Institute of Chartered Accountants in Scotland have taken a forward step and approved income determinations which would take into account changes in the purchasing power of the monetary unit with appropriate disclosure.

Cannot we in America consider the question whether changes in price levels have made changes in accounting desirable upon its merits rather than on the basis of traditions which are conventional, selective and oversimplified, if indeed they are traditions at all?

George O. May

Southport, Connecticut

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